Islamic Finance

Stage 3

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PREFACE

In the last few years, the world has witnessed significant growth in Islamic Banking and Finance and has recognized the importance of Islamic Banking system as one of the most viable and sustainable banking system. Especially after the last financial crises of the world, where most of the big conventional banks failed to sustain their existence, the steady performance of Islamic Financial Institutions has shown the strength and significance of this system to the masses.

Few years back Islamic Banks could only facilitate limited financial requirements of the customers but now solution is provided for almost all the financing needs of customers. This encouraging growth of Islamic Banking system now requires robust research in the field of Product Development and other related fields like Risk Management etc, to capitalize this rising demand and emerge as a system of first choice for the whole world.

In order to rise to the level of becoming the financial system of first choice, Islamic banks now need to focus on developing products and services that are unique in their nature rather than matching products and services of Conventional Banking system. This will give Islamic Financial system the real strength that is inherent in the modes of Islamic Banking and Finance. All this cannot be achieved without seeking and aligning knowledge about the Islamic Finance with the rapidly changing financial requirements of the society.

A need was felt that literature about Islamic Financial concepts should be available in such a language that is easily comprehendible by the masses and that literature must not only be a theoretical literature but also takes into account the recent developments in the financial world.

In this book, which is an updated version of my previous book-Meezan Bank Guide to Islamic Banking, an effort has been made to bridge the gap between the theoretical concepts of Islamic Banking and finance and their practical applications which would enable a reader to grasp the concepts in a convenient manner.

Following additions have been made in this version:

1) The Arabic text of all the Quranic Ayahs and Hadiths that were mentioned in the previous edition has been added in this book.
2) An effort has been made to include the sources of Hadiths or fiqh rulings to add to the credibility of the information available in the book.
3) To ensure uniformity all the translations of the Quranic verses have been replaced with the translations from "The Noble Quran" written by my father Justice Mufti Taqi Usmani.
4) The text of the old chapters have been updated and revised wherever it was required.
5) New chapters on emerging fields in Islamic Banking and Finance such as Risk Management for Islamic Banks, Treasury Operations, Import-Export Financing, Tawarruq, Takaful, Guarantees have been added in the book to discuss Shariah concepts applicable to all these recent developments.
6) A new chapter on "Shariah Audit" has been added in the book to discuss the unique nature and scope of Audit in the field of Islamic Banking and Finance.
7) Guidelines for accounting treatment of major modes like Murabaha, Ijarah and Istisna have been added in the book.

I am grateful to all team members who helped me prepare this Guide and gave me some very good suggestions. I am especially grateful to our colleague Maulana Bilal Ahmad Qazi for assisting me tirelessly in updating the materials of the book. I am also grateful to Mr. Ahmed Ali Siddiqui and Mr. Shayan Ahmed Baig from Product Development and Shariah Compliance Department of Meezan Bank Limited for their efforts in development of this updated version.

In the end I pray to Allah Subhanahu Wa Tallah to accept our efforts in His cause, and give us the guidance and ability for such humble efforts in future as well to free the world from Riba and revive Islamic values all over the world. Ameen.

Imran Usmani
Muharram 1434

Specific Learning Objectives (SLOs)

Part 1:
Islamic Banking–Introduction, Background & Global Scenario

By the end of this chapter you should be able to:

- Explain the concept of Islamic Shariah (Covered in Chapter 1)
- Explain the importance of Shariah in Islamic banking (Covered in Chapter 1)
- List the sources of Shariah (Covered in Chapter 1)
- Describe the concept of lawful and unlawful as per Shariah (Covered in Chapter 1)
- Explain the concept of free and fair market system in Islam (Covered in Chapter 3)
- Reading Material Discuss the global scenario of Islamic banking and its impact on traditional banking practices (Covered in Chapter 20) + Reading Material
- Explain the architechture of an islamic financial system and discuss its effectiveness (Covered in Chapter 2)
- Differentiate between Islamic economics and finance and capitalism and socialism (Covered in Chapter 2)
- Explain the concept of wealth in Islam (Covered in Chapter 2)
- Explain the objectives of wealth distribution in Islam (Covered in Chapter 3)
- Describe the factors of production in Islam and their compensations (Covered in Chapter 2)

Part 2:
Concept of Riba, Gharar and Qimar and Other Prohibited Activities

By the end of this chapter you should be able to:

- Define Riba in the lights of Quran and Hadith (Covered in Chapter 4)
- Explain the various types of Riba (Covered in Chapter 5)
- Discuss the point of view of Islamic banking on interest (Covered in Chapter 4 and 5)
- Differentiate between the concepts of Gharar and Qimar and explain why these are prohibited under Islamic Shariah (Covered in Chapter 30)
- Describe the other activities that are termed as prohibited under Islamic finance (Covered in Chapter 30)

Part 3:
Islamic Law of Contract

By the end of this chapter you should be able to:

- Define the Islamic law of contract (Covered in Chapter 6)
- Explain the basic elements of an Islamic contract (Covered in Chapter 6)
- Explain the scenarios under which an Islamic contract is termed void or valid (Covered in Chapter 6)
- Analyze the scenarios under which an Islamic contract is termed void or valid (Covered in Chapter 6)

- Define Uqood Muawadha and explain its importance in Islamic law of contract (Covered in Chapter 6)
- Define Uqood Ghair Muawadha and explain its importance in Islamic law of contract (Covered in Chapter 6)

Part 4: Islamic Law of Sale

By the end of this chapter you should be able to:

- Differentiate between the concepts of Bai Batil, Bai Fasid and Bai Makrooh (Covered in Chapter 8)
- Analyze the prohibited transactions under Islamic law of sale and purchase (Covered in Chapter 8)
- Explain the concepts of subject matter, price and delivery and possession under Islamic law of sale and purchase (Covered in Chapter 7)
- Describe the concept Khiyar and discuss the conditions under which Khiyar can be exercised (Covered in Chapter 9)
- Describe the concept of Iqala and discuss the conditions under which it can be exercised (Covered in Chapter 9)

Part 5: Comparison of Islamic and Conventional Banking

By the end of this chapter you should be able to:

- Differentiate between the concept of Islamic and conventional banking (Covered in Chapter 20)
- Differentiate between the governing principles and business model frameworks of Islamic and conventional banking (Covered in Chapter 20)
- Discuss the product level differentiation among the various products offered by Islamic and conventional banks (Covered in Chapter 20)
- Differentiate between the conceptual differences that exist in the documentation requirements of Islamic and conventional banking (Covered in Chapter 20)
- Differentiate the nature of relationship between customer and bank under Islamic banking (Covered in Chapter 20)
- Explain the concept of risk and reward under Islamic Shariah (Covered in Chapter 20)

Part 6: Categories of Islamic Modes

By the end of this chapter you should be able to:

- Identify the categories of Islamic modes of financing (Covered in Chapter 20)
- List the characteristics of trade based Islamic modes (Covered in Chapter 20)
- List the characteristics of participation based Islamic modes (Covered in Chapter 20)
- List the characteristics of rental based Islamic modes (Covered in Chapter 20)
- Analyze the factors on which trade based, rental based and participation based modes differ (Covered in Chapter 20)
- Differentiate between a disclosed agent and a non-disclosed agent (Covered in Chapter 6)
- Explain the concept of 'Wakalatul Istismar Contract (Portfolio Management)' under Islamic Shariah (Covered in Chapter 6)
- Differentiate among Waadah (unilateral promise), Muawadah (bilateral promise) and Aqd (contract) (Covered in Chapter 6)

- Describe the handling of trade finance under Islamic banking (Covered in Chapter 24 and 25)
- Describe Dhamanat under Islamic Banking - guarantee, mortgage, liquidated damages, letter of guarantee, collateral (Covered in Chapter 31)

Part 7: Islamic Products

By the end of this chapter you should be able to:

Murabaha

- Explain the concept of Murabaha and describe its variants as a financing mode used in Islamic financing (Covered in Chapter 4)
- Explain the characteristics and essentials of Shariah compliant Murabaha (Covered in Chapter 13)
- Explain the practical steps for Murabaha transactions (Covered in Chapter 13)
- Discuss the scope and application of Murabaha in global Islamic banking practices (Covered in Chapter 13)
- Discuss the common issues and mistakes that occur while dealing with Murabaha transactions (Covered in Chapter 13)
- Differentiate between Murabaha based financing and conventional bank lending (Covered in Chapter 13)
- Describe the possible risks Islamic banks may face while dealing in Murabaha transactions (Covered in Chapter 13)
- Analyze the scenarios where Islamic banks may face non compliance risk in Murabaha transactions (Covered in Chapter 13)
- Analyze the scenarios where Islamic banks may face risks while dealing in Murabaha transactions (Covered in Chapter 13)

Ijarah

- Explain the concept and basic rules governing Ijarah (Covered in Chapter 17)
- Discuss the rights and obligations of a lessor and lessee (Covered in Chapter 17)
- Recall the important conditions of Ijarah/lease (Covered in Chapter 17)
- Explain the concept of Ijarah Muntahia Bitamleek (Covered in Chapter 17)
- Distinguish Islamic Ijarah from conventional leasing (Covered in Chapter 17)
- Illustrate lease as a mode of Islamic financing (Covered in Chapter 17)
- Discuss the salient conditions of an Ijarah agreement (Covered in Chapter 17)

Musharakah

- Explain the concept and characteristics of Musharakah (Covered in Chapter 10)
- Describe the types and basic rules of Musharakah (Covered in Chapter 10)
- List the conditions for termination of Musharakah (Covered in Chapter 10)
- State constructive liquidation of Musharakah (Covered in Chapter 10)
- Describe the types of security/collateral used under Musharakah financing (Covered in Chapter 10)

- Describe the handling of profit/loss distribution under Musharakah financing (Covered in Chapter 10)
- Discuss the problems and risks for banks while dealing with Musharakah financing (Covered in Chapter 10)
- Analyze the scenarios for possible problems and risks that may exist for banks while dealing with Musharakah financing (Covered in Chapter 10)

Diminishing Musharakah

- Explain the concept of Diminishing Musharakah (Covered in Chapter 12)
- Explain the basic features of Diminishing Mushrakah based on Shirkat ul Milk (Covered in Chapter 12)
- Describe all the steps involved in a Diminishing Musharakah transaction (Covered in Chapter 12)
- Explain the concept of lease rentals in Diminishing Musharakah (Covered in Chapter 12)
- Explain unilateral promise and transfer of ownership title under Dimin ishing Mushrakah transactions (Covered in Chapter 12)
- Discuss the role of Diminishing Mushrakah as a financing mode under Islamic banking (Covered in Chapter 12)

Mudarabah

- Explain the concept and characteristics of Mudarabah (Covered in Chapter 11)
- Describe the handling of profit/loss distribution under Mudarabah (Covered in Chapter 11)
- Differentiate between unrestricted and restricted Mudarabah (Covered in Chapter 11)
- Differentiate between Mudarabah and Musharakah (Covered in Chapter 11)
- Explain the conditions of Mudarabah termination (Covered in Chapter 11)
- Describe how Mudarabah finance capital is generated (Covered in Chapter 11)
- Discuss the scope of Mudarabah for banking system (Covered in Chapter 11)
- Identify the problems and risks for Islamic banks providing Mudarabah based financing (Covered in Chapter 11)
- Analyze the scenarios for possible problems and risks that may exist for Islamic banks providing Mudarabah based financing (Covered in Chapter 11)

Salam

- Explain the concept, background and purpose of Salam (Covered in Chapter 14)
- List the rules for a valid salam contract (Covered in Chapter 14)
- Differentiate between Salam and Murabaha contract/agreement (Covered in Chapter 14)
- Describe the underlying conditions for taking delivery of Salam goods (Covered in Chapter 14)
- Explain the concept of parallel Salam (Covered in Chapter 14)

- Differentiate between the application of Salam and parallel Salam (Covered in Chapter 14)
- Describe the possible risks that can arise while dealing in Salam contracts (Covered in Chapter 14)
- Discuss the scope and potential of Salam in global Islamic banking practices (Covered in Chapter 14)

Istisna

- Explain the concept and basic rules governing a valid Islamic Istisna (Covered in Chapter 15)
- Explain the concept of payment in Istisna (Covered in Chapter 15)
- Differentiate between Salam and Istisna contract (Covered in Chapter 15)
- Define parallel Istisna (Covered in Chapter 15)
- Differentiate between the application of Istisna and parallel Istisna (Covered in Chapter 15)
- Explain application of Istisna in Islamic corporate finance (Covered in Chapter 15)
- Describe the possible risks that can arise while dealing in Istisna contracts (Covered in Chapter 15)
- Analyze the scenarios for possible risks that can arise while dealing in Istisna contracts (Covered in Chapter 15)

Part 8: Liability products of Islamic banks

By the end of this chapter you should be able to:

- Explain the concept of deposit (liability) management in Islamic Banks (Covered in Chapter 21)
- Differentiate the handling of deposits between Islamic and conventional banks (Covered in Chapter 21)
- Describe the profit calculation mechanism and weightages assignment method as used in liabilities management in Islamic banks (Covered in Chapter 21)

Part 9: Concept of Takaful (Islamic Insurance)

By the end of this chapter you should be able to:

- Recall the basic concept and characteristics of Takaful (Covered in Chapter 30)
- Differentiate between Insurance and Takaful (Covered in Chapter 30)
- List the popular models of Takaful being used by Islamic banks today (Covered in Chapter 30)

Part 10: Overview of Securitization and Sukuk

By the end of this chapter you should be able to:

- Define the concept of securitization (Covered in Chapter 27)
- Define securitization of Musharakah, Mudarabah & Ijarah (Covered in Chapter 27)
- Define liquidity management through securitization (Covered in Chapter 26 and 27)

- Explain the concept of Sukuk al Ijarah (Covered in Chapter 27)
- Illustrate the concept of corporate finance transactions under the Islamic banking (Covered in Chapter 22 and 23)
- Discuss the methodology of assets and fund management as per Islamic banking concepts (Covered in Chapter 28)

Part 11: Introduction to AAOIFI standards

By the end of this chapter you should be able to:

- Recall salient features of accounting standards of various modes
- Define AAOIFI
- Explain the adaptation of AAOIFI (Accounting and Auditing Organization for Islamic Finance Institutions) Standards by ICAP (Institute of Chartered Accountants of Pakistan)
- List the Shariah standards adopted by Pakistan
- Discuss the Islamic banking framework given by the SBP

Note

As per Additional Reading Material please visit IBP website

www.ibp.org.pk

Chapter 1

Islamic Economic System

Islamic Economic System

Introduction

Islamic Economic system is a system which is in conformity with the rules of Shariah. Shariah can be explained as a "Pathway to be followed" and can further be explained as a set of divine injunctions and laws that regulates every aspect of human beings in their individual and collective lives.

All aspects of individual and collective life of a human being can be divided into following five categories. Thus Shariah provides a pathway to be followed in all these categories:

1) Beliefs (Aqaid) / عقائد
2) Acts of Worship (Ibadaat) / عبادات
3) Dealing with others (Muamlaat) / معاملات
4) Manners (Ikhlaqiat) / اخلاقیات
5) Economics (Maishat) / معیشت

The nature of Shariah rulings are as follows:

1) Halaal (All those acts that are permitted and declared lawful by Shariah)

2) Haraam (All those actions that are prohibited and declared unlawful by Shariah and their impressibility is derived from either Quran a Hadiths Mutawatir or Ijma. Sunnah e Mutawaatirah is the strongest narration of the Holy Prophet in terms of its narrators, i.e. the narrators are in such a large number that it is impossible for all of them to agree on a false issue

3) Faraiz (All those actions that are declared mandatory by either Quran or Sunnah e Mutawaatirah or Ijma)

4) Wajibaat (All those actions that are declared mandatory on Muslims by the narrations which are not as strong in terms of narrators as Sunnah Al Mutawaatirah)

5) Sunnah (All those actions that are recommended to be performed by Muslims, based upon the association of those actions with Holy Prophet ﷺ

6) Nawafil (All those actions which are made optional and rewardable on Muslims by Shariah)

Sources of Shariah

The rules and regulations laid down by Islamic Shariah are derived from the following major sources.

1) Quran
2) Hadiths
3) Ijma
4) Qiyas
5) Ijtihad

Quran

Quran is the word of Allah Ta'ala revealed over Prophet Muhammad ﷺ. The Quran is the primary source of Knowledge and Shariah rulings for Muslims. The injunctions mentioned in the Holy Quran are mandatory to follow and anyone who denies express injunctions of Holy Quran is regarded as Non-Muslim. Most of the injunctions mentioned in the Holy Quran are prescriptive in nature such as Order for offering Salah but information about method and other descriptive information about offering Salah may be obtained from other sources of Shariah such as Sunnah:

وَأَطِيعُوا اللَّهَ وَرَسُولَهُ إِنْ كُنْتُمْ مُؤْمِنِينَ (سورة الأنفال اية 1)

And obey Allah and His Messenger, if you are believers (8:1)

Sunnah:

Sunnah is defined as a word spoken or act done or rectified by the Holy Prophet ﷺ .The Sunnah provides detailed information about the code of conduct for every sphere of life and is also considered as Divine Revelation. The details about Sunnah are preserved in the form of Ahadiths. On the basis of clear injunctions of Holy Quran, Sunnah can thus be regarded as the second source of Islamic Shariah after Quran e.g. Rules for Rib Ul Fadal has been extracted from Sunnah.

Ijma

Ijma means consensus of scholars of Ummah on a particular issue. It is one of the most authoritative sources of Islamic Shariah since it encompasses unanimous opinion of the scholars of a particular era over the interpretation of Quran and Hadiths on some particular issue. The status of Ijma as an authoritative source of Shariah has also been ascertained from the following saying of Holy Prophet ﷺ :

إن الله تعالى لا يجمع أمتي علی ضلالة، ويد الله تعالى مع الجماعة، من شذ شذ إلى النار
(كنز العمال في سنن الأقوال و الأفعال)

"Allah's hand is with congregation and one who keeps him self in solitude with forcefully be kept in solitude in the fire"

Qias

Qiyas is to apply a recognized rule of Shariah expressly mentioned in the Holy Quran and Sunnah to a similar thing or situation by way of analogy.

Ijtihad

Ijtihad literally means Utmost Effort and technically it means to exert utmost effort to discover a ruling of Shariah regarding a particular situation. The practice of Ijtihad has been duly endorsed by Prophet Muhammad ﷺ through following narration:

When the Holy Prophet ﷺ intended to send his companion Hazrat Mu'adh رضي الله تعالى عنه to Yaman as a ruler and as a judge, he asked him: How will you adjudicate a matter when it will come to you?

He said, "I shall decide on the basis of Allah's Book (the Holy Quran)"

The Holy Prophet ﷺ asked, "If you do not find it in Allah's Book (what will you do)?

He said: "then, on the basis of the Sunnah of Allah's Messenger".

"If you do not find it even in the Sunnah of Allah's Messenger (what will you do)? The Holy Prophet ﷺ asked.

He replied: "I shall make ijtihad on the basis of my understanding and will not spare any effort (to reach the truth).

On this the Holy Prophet ﷺ tap the chest of Hazrat Mu'adh رضي الله تعالى عنه with happiness and said, "Praise be to Allah, who has let the messenger of the messenger of Allah to do what pleases Allah's messenger". (Abu Dawood)

It is an important and often misunderstood question whether the doors of Ijtihad are still open or not. For all those issues where there are clear injunctions of Holy Quran, Sunnah and Ijma then Ijtihad cannot be done on those issues. Ijtihad can only be done on those new issues and situations where no explicit injunctions of Shariah are available or there are some meticulous changes that require further exploration of the issue by the Scholars. It is also important to note that Ijtihad is not merely one's own opinion based on rational judgment but it is indeed the result of un-biased and utmost effort of Mujtahid on the basis of principles laid down by Shariah and it must not contradict with any clear-cut rule of Islamic Shariah. On the basis of com

plex nature of Ijtihad, not every scholar can perform Ijtihad but the most learned, senior and the pious of the scholars are eligible for the role of Mujtahid who have detailed knowledge about Quran, Tafasir, Arabic, Background of the revelation of verses of Quran, Ahadiths, Usool e Fiqh etc.

Introduction of Islamic Economics

One of the forms of capitalism, which has been flourishing in non-Islamic societies of the world, is the interest-based investment. There are normally two participants in such transactions. One is the Investor who provides capital as loan for interest and the other is the Manager who runs the business. The investor has no concern whether the business runs into profit or loss, he automatically gets an interest (Riba) in both outcomes at a fixed rate on his capital. Islam prohibits this kind of business and the Holy Prophet ﷺ enforced this ruling, not in the form of some moral teaching, but as the law of land in Islam.

It is very important to know the definition and forbiddance of Riba and the injunctions relating to its unlawfulness from different angles. On one hand, there are severe warnings of the Qur'an and Sunnah and on the otherhand it has been taken today as an integral part of the world economy. The desired liberation from it seems to be infested with difficulties. The problem is very complex, has to be taken up in all possible aspects.

First of all, we have to deliberate into the correct interpretation of the Quranic verses on Riba and what has been said in authentic ahadith and then determine what Riba is in the terminology of the Quran and Sunnah, which transactions it covers? what is the underlying wisdom behind its prohibition? and what sort of harm it brings to society? We will start from looking at the economic philosophy of Islam vis-a-vis interest.

The economic philosophy of Islam vis-a-vis Interest

The economic philosophy of Islam has no concept of Riba because according to Islam, Riba is that curse in society, which accumulates wealth among handful of people, and results inevitably in creating monopolies, opening doors for selfishness, greed, injustice and oppression. In an interest based economy, deceit and fraud prospers in the world of trade and business. Islam, on the other hand, primarily encourages highest moral ethics such as universal brotherhood, collective welfare and prosperity, social fairness and justice. Due to this reason, Islam renders Riba as absolutely haram and strictly prohibits all types of interest based transactions.

The prohibition of Riba in the light of economic philosophy of Islam can be explained vis-a-vis distribution of wealth in a society.

Distribution of wealth

The distribution of wealth is one of the most important and most controversial

subjects concerning the economic life of man, which has given birth to global revolutions in today's world, and has affected every sphere of human activity from international politics down to the private life of the individuals. For many a centuries now, the question had not only been the center of fervent debates, but also of armed conflicts. The fact, however, is that whatever has been said on the subject without seeking guidance from Divine Revelation and relying merely on human reason, has had the sole and inevitable result of making the confusion worse confounded.

Islamic perspective of distribution of wealth

In this chapter, we propose to state as clearly and briefly as possible the point of view of Islam in this matter, such as we have been able to deduce from the Holy Qur'an, the Sunnah and the writings of the Shariah research scholars on the distribution of wealth in the Islamic context.

Before explaining the point, it is imperative to clarify certain basic principles which one can derive from the Quran, and which distinguish the Islamic point of view about economics from non-Islamic point of view about economy.

1. The importance of the economic goals

No doubt, Islam is opposed to monasticism, and views the economic activities of man quite lawful, meritorious, and some times even obligatory and necessary. It approves of the economic progress of man, and considers lawful or righteous livelihood an obligation on every individual. Notwithstanding all this, it is no less a truth that it does not consider "economic activity" to be the basic problem of man, nor does it view economic progress as the be-all and end-all of human life.

Many misunderstandings about Islamic economics arise just from the confusion between the two facts i.e considering economics as the ultimate goal of life and further considering it as a necessity in order to have a prosperous life through lawful means. Even human logic can comprehend to show that an activity being lawful, or meritorious or necessary is different from it being the ultimate goal of human life and the center of thought and action. It is, therefore, very essential to make this distinction as clear as possible at the very outset. In fact, the profound, basic and far-reaching difference between Islamic economics and materialistic economics can be summarized as:

According to materialistic economics:

"Livelihood is the fundamental problem of man and economic developments are the ultimate end of human life"

While according to Islamic economics:

"Livelihood is necessary and indispensable, but cannot be the true purpose of human life"

So, while we find in the Holy Quran, the disapproval of monasticism and the order to:

وابتغوا من فضل اللَّهَ (سورة الجمعة أية 10)

"Seek the grace of Allah."(62:10)

At the same time we find in the Quran to restrain from the temptations or delusion for worldly life. And all these things in their totality have been designated as "Ad-Dunya" ("the mean") - a term which, in its literal sense, does not have a pleasant connotation.

Apparently one might feel that the two commands are contradictory, but the fact is that according to the Quranic view, all the means of livelihood are no more than just stages of man's journey, and his final destination lies beyond them. This destination is achieved by good intention and through rightful means of earning livelihood in this world. The real problem of man and the fundamental purpose of his life is the attainment of these-two goals. But one cannot attain them without traversing the path of this world. So, all those things too which are necessary for his worldly life, become essential for man. It comes to mean that so long as the means of livelihood are being used only as a path leading towards the final destination, they are the benevolence of Allah, but as soon as man gets lost in the mazes of this pathway and allows himself to forget his real destination, the very same means of livelihood turn into an "temptation, or delusion" "trial":

"وَاعْلَمُوْا انَّمَا أَمْوَالكُمْ وَأَوْلَادكُمْ فِتْنَة " (سورة الأنفال أية 28)

"And be aware that your possessions and your children are but a trial" (8:28).

The Holy Quran has enunciated this basic truth very precisely in a brief verse:

"وابتغ فِيْمَا آتاكَ الله الدَّارَ الآخِرَةَ " (سورة القصص أية 77)

"And seek the (betterment of the) Ultimate Abode with what Allah has given to you" (28:77).

This principle has been stated in several other verses too.
This attitude of the Holy Quran towards "the economic activity" of man and its two aspects would be very helpful in solving problems of man in Islamic economics.

2. The real nature of wealth and property

The other fundamental principle, which can help solve the problem of the distribution of wealth, is the concept of "wealth" in Islam. According to the illustration of the Holy Quran "wealth" in all its possible forms is a thing created by Allah, and is, in principle His "property". Allah delegates the right of property over a thing, which accrues to man, to Him. The Holy Quran explicitly says:

"وَآتُوْهُمْ مِن مَالِ اللَّهَ الذِي آتاكُم" (سورة النور أية 33)

"Give to them from the property of Allah which He has bestowed upon you." (24:33).

According to Quran the reason for this philosophy is that all a man can do is invest his labor into the process of production. But Allah alone, and no one else, can cause this endeavor to be fruitful and actually productive. Man can do no more than sow the seed in the soil, but to bring out a seedling from the seed and make the seedling grow into a tree is the work of someone other than man. The Holy Quran says:

"أفرَأيتُمْ مَا تَحْرُثُوْن ،أأنتُمْ تَزْرَعُوْنَهُ أمْ نَحْنُ الزَّارِعُوْن"(سورة الواقعة أية 63-64)

"Well, tell Me about that (seed) which you sow:[63] Is it you who grow it, or are We the One who grows?[64]" (56:63-64) And in another verse

"اولَمْ يَرَوْا انَّا خَلَقْنَا لَهُمْ مِمَّاعَمِلَتْ ايْدِيْنَا انْعَامًا فَهُمْ لَهَا مَالِكُوْن"(سورة يس أية 71)

"Did they not see that We have created for them cattle, among things made (directly) by Our hands, and then they become their owners? (36:71)

All these verses throw ample light on the fundamental point that "wealth", no matter what its form, is in principle "the property of Allah", and it is He who has bestowed upon man the right to exploit it. So Allah has the right to demand that man should subordinate his exploitation of this wealth to the commandments of Allah.

Thus, man has the "right of property" over the things he exploits, but this right is not absolute or arbitrary or boundless, it carries along with it certain limitations and restrictions, which have been imposed by the real owner of the 'wealth'. We must spend it where He has commanded it to be spent, and refrain from spending where He has forbidden. This point has been clarified more explicitly in the following verse:

"وَابْتَغِ فِيْمَا آتاكَ اللَّهَ الدَّارَ الآخِرَةَ وَلاَ تَنسَ نَصِيْبَكَ مِنَ الدُّنْيَا وَأحْسِنْ كَمَا أحْسَنَ اللَّهَ اِلَيكَ وَلاَ تَبْغِ الفَسَادَ فِي الأرْض "(سورة القصص أية 77)

"And seek the (betterment of the) Ultimate Abode with what Allah has given to you, and do not neglect your share from this world, and do good as Allah did good to you, and do not seek to make mischief in the land" (28:77)

This verse fully explains the Islamic point of view on the question of property. It places the following guidelines before us:

(1) Whatever wealth man does possess has been received from Allah.

(2) Man has to use it in such a way that his ultimate purpose should be to seek the bounties and blessings of Allah in this world and hereafter.

(3) Since wealth has been received from Allah, its exploitation by man must necessarily be subject to the commandment of Allah.

(4) Now, the Divine Commandment has taken two forms:

a) Allah may command man to convey a specified production of "Wealth" to another man. This Commandment must be obeyed, because Allah has done good to you, so He may command you to do good to others - "do good as Allah has done good to you".

b) He may forbid you to use this "wealth" in a specified way. He has every right to do so because He cannot allow you to use "wealth" in a way which is likely to produce collective ills or to spread disorder on the earth.

This is what distinguishes the Islamic point of view on the question of property from the Capitalist and Socialist point of view. Since the mental background of Capitalism is, theoretically or practically, materialistic, it gives man the unconditional and absolute right of property over his wealth, and allows him to employ it, as he likes. But the Holy Quran has adopted an attitude of disapprobation towards this theory of property, in quoting the words of the nation of Hazrat Shu'aib عليه سلام They used to say:

'أصَلاَ تُكَ تَأمُرُكَ أنْ نَتْرُك مَا يَعْبُدُ آبَاؤُنَا أوْ أنْ نَفْعَلَ فِيْ أمْوَالِنَا مَا نَشَآء" (سورة الهود أية 87)

"Does your Salah (prayer) command you that we should forsake what our fathers used to worship or that we should not deal with our wealth as we please??" (11:87)

These people used to consider their property as really theirs or "Our property", and hence the claim of "doing what we like" was the necessary conclusion of their position. But the Holy Quran has, in the chapter "Light" substituted the term "the property of Allah" for the expression "Our possessions", and has thus struck a blow at the very root of the Capitalistic way of thinking. But at the same time, by adding the qualification "what Allah has bestowed upon you", it has cut the roots of Socialism as well, which starts by denying man's right to private property. Similarly, ("thus they acquired the right property over them") - a verse in the Chapter "Seen", explicitly affirms the right to private property as a gift from Allah.

Difference between Islam, Capitalism and Socialism

Now we are in a position to draw clear boundary lines that separate Islam, Capitalism and Socialism from one another:

Capitalism affirms an absolute and unconditional right to private property. Socialism totally denies the right to private property.

But the truth lies between these two extremes - i.e. Islam admits the right to private property but does not consider it to be an absolute and unconditional right that is bound to cause "disorder on the earth".

Chapter 2

Factors Of Production In Islam

For better understanding of the Factors of Production in Islam, We now compare the factors of production in various economic systems including Capitalism and Socialism.

The Capitalist View

In order to understand the Islamic point of view fully, it would be better to have a look at the system of the distribution of wealth that is obtained under the capitalist economy. This theory can be briefly stated like this: ***wealth should be distributed only over those who have taken part in producing it, and who are described in the terminology of economics as the factors of production.*** According to the Capitalistic economics, these factors are four:

1. **Capital:** which has been defined as "the produced means of production" - In other words, a commodity which has already undergone one process of human production, and is again being used as a means of another process of production.

2. **Labor:** It is defined as, any exertion on the part of man.

3. **Land:** which has been defined as ''natural resources'' (i.e. those things which are being used as means of production without having previously undergone any process of human production)

4. **Entrepreneur or Organization:** The fourth factor that brings together the other three factors, exploits them and bears the risk of profit and loss in production.

Under the Capitalist economy, the wealth produced by the co-operation of these four factors is distributed over these very four factors as follows: one share is given to Capital in the shape of interest, the second share to Labor in the shape of wages, the third share to Land in the shape of rent (or revenue), and the fourth share (or the residue) is reserved for the Entrepreneur in the shape of profit.

The Socialist View

On the other hand, under the Socialist economy, capital and land instead of being private property, are considered to be national or collective property. So, the question of interest or rent (or revenue) does not arise at all under the philosophy of this system. Under the Socialist system, the entrepreneur too is not an individual but the state itself. So profit, as well, is out of the question here - at least in theory. Now, there remains only one factor

namely labor. And labor alone is considered to have a right to wealth under the Socialist system, which it gets in the shape of "Wages".

Let it be made clear that we are here concerned with the basic philosophy or theory of socialism, and not with its present practice, for the actual practice in socialist countries is quite different from this theory.

The Islamic View

The Islamic system of the distribution of wealth is different from both Capitalist and Socialist economic system. From the Islamic point of view, there are two kinds of people who have right to wealth:

1. **Primary Right to Wealth:**

   Primary right denotes the right to wealth which is directly in consequence of participation in the process of production. In other words, primary right is for those "factors of production" which have contributed part in the process of producing some kind of wealth.

2. **Secondary Right to Wealth:**

   Secondary right holders are those who have not directly contributed in the process of production, but it has been enjoined upon the producers to make them co-sharers in their wealth e.g. Beneficiaries of Sadaqat-ul-Wajibaat.

Islamic Theory

Those who have a primary right to wealth

As indicated above, the primary right to wealth is enjoyed by "the factors of production." But "the factors of production'' as per Islamic theory are not specified or technically defined, nor is their share in wealth determined in exactly the same way as is done under the Capitalist system of economy. In fact, the two ways are quite distinct. From the Islamic point of view, the actual factors of production are three instead of being four:

1. **Capital:** It is defined as means of production that cannot be used in the process of production until and unless during this process they are either wholly consumed or completely altered in form, and which, therefore, cannot be let or leased (for example, liquid money or food stuff etc.) The share of capital is in the form of profit (and not interest).

2. **Land:** That is, those means of production, that are used in the process of production that their original and external form remains unaltered, and which can hence be let or leased (for example, lands, houses, machines etc.). Its share is in the form of rent.

3. **Labor:** That is, human exertion, whether of the bodily organs or mind or heart. This exertion thus includes organization and planning too. The share of labor comes in the form of wages. In case of Mudarbah the compensation of labor will be in the form of profit.

Whatever "wealth" is produced by the combined action of these three factors would be primarily distributed over these three factors.

Socialism and Islam

As we said, the Islamic system of the distribution of wealth is different from Socialism and Capitalism both. The distinction between the Islamic economy and the Socialist economy is quite clear. Since Socialism does not admit the idea of private property, wealth under the Socialist system is distributed only in the form of wages. On the contrary, according to the Islamic principles of the distribution of wealth, which we have outlined above, all the things that exist in the universe are in principle the property of Allah Himself. Then, the larger part of these things has been given equally to all men as a common trust. It includes fire, water, earth, air, light, wild grass, hunting, fishing, mines, un-owned and un-cultivated lands etc., which are not the property of any individual, but a common trust. Every human being is the beneficiary of this trust, and is equally entitled to its use.

On the other hand, there are certain things where the right to private property must be recognized in order to establish the practicable and natural system of economy. If the Socialist system is adopted and all capital and land are totally surrendered to the state, the ultimate result can only be that: we would be liquidating a large number of smaller Capitalists, and putting the huge resources of national wealth at the disposal of a single big Capitalist - the state, which can deal with this reservoir of wealth quite arbitrarily, thus, leads to the worst form of the concentration of wealth. Moreover, it produces another great evil. Since Socialism deprives human labor of its natural right to individual choice and control, compulsion and force becomes indispensable in order to make use of this labor, which has a detrimental effect on its efficiency as well as on its mental health. All this goes to show that the Socialist system injures two out of the three objects of the Islamic theory of the distribution of wealth namely, the establishment of a natural system of economy, and securing for everyone what rightfully belongs to him.

These being the manifold evils inherent in the unnatural system of the Socialist economy, Islam has not chosen to put an end to private property altogether, but has rather recognized the right to private property in those things of the physical universe which are not held as a common trust. Islam has, thus, given a separate status to Capital and to Land, and has at the same time made use of the natural law of "supply and demand" too in a healthy form. Hence Islam does not distribute wealth merely in the form of wages, as does Socialism, but in the form of profit and rent as well. But, along with it, Islam has also put an interdiction on the category of' 'Interest'',

and prescribed a long list of the people who have a secondary right to wealth. It has thus eradicated the great evil of the concentration of wealth, which is an essential characteristic inherent in Capitalism, an evil, which Socialism claims to remedy. This is the fundamental distinction of the Islamic view of the distribution of wealth, which sets it apart from Socialism.

It is equally essential to understand fully the difference that exists between the Islamic view of the distribution of wealth and the Capitalist point of view. This distinction being rather subtle and complicated, we will have to discuss it in greater detail.

By comparing and contrasting the brief outlines of the Islamic and the Capitalist systems of the distribution of wealth, we arrive at the following differences between the two:

1. The entrepreneur, as a regular factor, has been excluded from the list of the factors of production, and only three factors have been recognized, instead of four. But this does not imply that the very existence of the entrepreneur has been denied. What it does mean is just that the entrepreneur is not an independent factor, but is included in any one of the three factors.

2. It is not "interest" but "profit" that has been considered as the "reward" for Capital.

3. The factors of production have been defined in a different manner. Capitalism defines "Capital'' as "the produced means of production." Hence, Capital is supposed to include machinery etc. as well, beside money and foodstuff. But the definition of "Capital" that we have presented while discussing the Islamic view of the distribution of wealth, includes only those things which cannot be utilized without their being wholly consumed, or, in other words, which cannot be let or leased - for example, money. Machinery is to be excluded from "Capital", according to this definition.

4. All those things have been brought under "land", which do not have to be wholly consumed in order to be used. Hence, machinery too falls under this category.

5. The definition of "Labor" too has been generalized so as to include mental labor and planning.

Let us now go into the details of this discussion. Under the Capitalist system, the most important characteristic of the entrepreneur (which entitles him to "profit") is supposed to be that he bears the risk of profit and loss in his business. From the Capitalist point of view, "profit'' is a kind of reward for his courage to enter into a commercial venture where he alone will has to bear the burden of a possible loss, while the other three factors

of production will remain immune from loss, for Capital would get the stipulated interest, Land the stipulated rent and Labor the stipulated wages

On the other hand, the Islamic point of view insists that the ability to take the risk of a loss should, in reality, be inherent with Capital itself, and that no other factor should be made to bear the burden of this risk. Consequently, the Capitalist, in so far as he takes the risk, is an entrepreneur too, and the man who is an entrepreneur is a Capitalist as well.

Now, there are three ways in which Capital can be invested in a business venture:

Ways of Capital Investment

1. **Private business:** The man who invests Capital may himself run the business without the help of any partners or shareholders. In this case the return which he gets may be called "profit" from the legal or popular point of view; but, in economic terms, this "reward" would be made up of (1) "profit", in as much as Capital has been invested, and (2) "wages", as earnings of management.

2. **Partnership:** The second form of investment is that several persons may jointly invest capital, jointly manage the business and jointly bear the risk of profit and loss. In the terminology of the Fiqh, such a venture is called "Shirkat-ul-Aqd" or Partnership in contract.

According to the terminology of economics, in this case too all the partners will be entitled to "profit" in so far as they have invested capital and also entitled to "wages" in so far as they have taken part in the management of the business. Islam has sanctioned this form of business organization too. This form was quite common before the time of the Holy Prophet ﷺ until he permitted people to retain it, and since then there has been a consensus of opinion on its permissibility.

3. **Co-operation of Capital and Organization (Mudarabah):** The third form of investment is that one person may invest Capital while another may manage the business, and each may have a share in the profit. In the terminology of Fiqh, it is called "Mudarabah". According to the terminology of economics, in this case, the person who invests his capital ("Rabb-ul-Mal") will get his share in the form of "profit", while the person who has actually managed the business will get it in the form of "wages". But if the person who has been managing the business ("Mudarib") eventually suffers a loss in the business, his labor will go wasted just as the capital of the investor would go wasted.

This form of business organization too is permissible in Islam. The Holy Prophet has made such an agreement with Hazrat Khadijah before their marriage. Since then there has been a complete consensus of opinion on this among the jurists of Islam.

Money Lending Business

The fourth form of investing Capital, which has ever since been practiced in non-Islamic societies is the money-lending business. As per this business, one person lends out capital in the form of a debt, and a second person puts in his labor; if there is a loss it has to be borne by labor, but regardless of profit or loss, interest does accrue to Capital in any case. Islam has interdicted this form of investment.

"يا أَيُّهَا الَّذِيْنَ اٰمَنُوْا اتَّقُوْا اللّٰهَ وَذَرُوْا مَا بَقِيَ مِنَ الرِّبٰوا اِنْ كُنْتُمْ مُؤْمِنِيْنَ"(سورة البقرة أية 278)

"O you who believe, fear Allah and give up what still remains of riba, if you are believers." (2:278)

The Holy Quran also says:

"فَاِنْ لَّمْ تَفْعَلُوْا فَأْذَنُوْا بِحَرْبٍ مِنَ اللّٰهِ وَرَسُوْلِهِ وَاِنْ تُبْتُمْ فَلَكُمْ رُؤُوْسُ اَمْوَالِكُمْ لَا تَظْلِمُوْنَ وَلَا تُظْلَمُوْنَ" (سورة البقرة أية 279)

"But if you do not (give it up), then listen to the declaration of war from Allah and His Messenger. However, if you repent, yours is your principal. Neither wrong, nor be wronged." (2:279)

In these two verses, the phrases "what is still due to you from the interest" and "you shall have the principal" makes it quite explicit that Allah does not condone the least quantity of interest, that "giving up the interest" implies that the creditor should get back only the principal. Thus, one can clearly see that Islam considers every rate of interest to be totally inadmissible. In the pre-Islamic period, certain Arab tribes used to carry on their trade with the help of money borrowed on the basis of interest from other tribes. Islam puts an end to such transactions altogether. Ibn Juraij says:

"In the pre-Islamic period, the tribe of Banu Amr bin Auf used to take interest from the tribe of Banu-al-Mughira, and the Banu-al-Mughira used to pay this interest. When Islam came, the later owed a considerable amount of money to the former". And further on:

"The Banu-al-Mughira used to pay interest to the Banu Thaqif"

Let it be understood that the position of every Arab tribe was like that of a joint company, carrying on trade with the joint Capital of its individual members. So, when a tribe would borrow collectively from another tribe, it would usually be for the purposes of trade. The Holy Quran prohibited even this practice.

Thus, under the Islamic system of economy, if a man wants to lend his money to a businessman for being invested in business, he will have first to decide whether he wishes to lend this money in order to have a share in the profit, or simply to help the businessman with his money. If he

means to earn the right to a share in the profit by lending his money, he will have to adopt the mode of "partnership" or that of "Co-operation" (Mudarabah) then, he too will have to bear the responsibility of profit or loss - if there is eventually a profit in the enterprise, he shall have a share in the profit; but if there is a loss, he shall have to share the loss too proportionate to this investment.

On the other hand, if he is lending this money to another person by way of help, then he must necessarily regard this help as no more than help, and must forgo all demand for a "profit". He will be entitled to get back only as much money as he has lent out. Islam considers it not only unjust but also meaningless that he should fix a rate of "interest" and thus place all the burden of a possible loss on the debtor.

This discussion makes it clear that Islam places the responsibility of ''taking the risk of loss'' on Capital. The man who invests capital in a risk-bearing business enterprise shall have to take this risk.

Chapter 3

The Objectives Of The Distribution Of Wealth In Islam

If we consider the injunctions of the Holy Quran, it would appear that the system for the distribution of wealth laid down by Islam envisages three objects:

a) The establishment of a practicable system of economy

The first object of the distribution of wealth is that it would be the means of establishing in the world a system of economy which is natural and practicable, and which, without using any compulsion or force, allows every individual to function in a normal way according to his ability, his aptitude, his own choice and liking, so that his activities may be more fruitful, healthy and useful. And this cannot be secured without a healthy relationship between the employer and the employee, and without the proper utilization of the natural force of supply and demand. That is why Islam does admit these factors. A comprehensive indication of this principle is to be found in the following verse:

نَحْنُ قَسَمْنَا بَيْنَهُمْ مَعِيشَتَهُمْ فِي الْحَيٰوةِ الدُّنْيَا وَ رَفَعْنَا بَعْضَهُمْ فَوْقَ بَعْضٍ دَرَجٰتٍ لِيَتَّخِذَ بَعْضُهُمْ بَعْضاً سُخْرِيًّا.(سورة الزخرف أية 32)

"We have allocated among them their livelihood in the worldly life, and have raised some of them over others in ranks, so that some of them may put some others to work." (43:32)

The condition of "proper utilization" has been assumed because it is possible to make an improper use of forces, and it has been the case under Capitalism. Islam has struck at the very root of such an improper use and has thus eradicated the unbridled exploitation of private property.

Free and Fair Market System in Islam:

Islam gives a basic freedom to enter into any type of Business or transaction provided that the business or transaction is Halaal and does not violate any of the ordain of Islam. Just as Islam does not restrict any one from entering into any Halaal economic transaction, similarly Islam also does not lay any imposition on price determination in an economy and recognizes the market forces of supply and demand in determining the price and does not restrict any particular level of profit margin to be charged but encourages moral ethics to be followed in determining the price. In general, Islam does not encourage the interference of state or any of the stakeholder in determining the prices in an economy. If some of the players of the market

are manipulating some of the market forces then state is required to interfere and regularize the market. During the caliphate of Hazrat Umer Farooq, رضی اللہ تعالیٰ عنہ one trader was selling goods at a price much lower than the market. The Caliph ordered the trader either to raise the price up to the market level or leave the market. The reason for this order was to regularize the market and safeguard the interest of other traders who are following the free market prices. In the same manner state can also interfere in cases where some of the stakeholders are involved in Hoarding and artificially *manipulating the market.*

b) Enabling every one to get what is rightfully due to him

The second object of the Islamic system of the distribution of wealth is to enable everyone to get what is rightfully his. But, in Islam, the concept and criteria of this right is somewhat different from what it is in other systems of economy. Under materialistic economic systems, there is only one way of acquiring the right to ''wealth'', and that is a direct participation in the process of production.

In other words, only those factors that have taken a direct part in producing wealth are supposed to be entitled to a share in "wealth", and no one else. On the contrary, the basic principle of Islam in this respect is that "wealth" is the property of Allah Himself and He alone can lay down the rules as to how it is to be used. So according to the Islamic point of view, not only those who have directly participated in the production of wealth but those to whom Allah has made it obligatory upon others to help, are the legitimate sharers in wealth. Hence, the poor, the helpless, the needy, the paupers and the destitute - they too have a right to wealth. For Allah has made it obligatory on all those producers of wealth among whom wealth is in the first place distributed that they should pass on to them some part of their wealth. And the Holy Quran makes it quite explicit that in doing so they would not be obliging the poor and the needy in any way, but only discharging their obligation, as the poor and the needy are entitled to a share in wealth as a matter of right. Says the Holy Quran:

الذِيْنَ فِي أمْوَالِهِمْ حَقّ مَعْلُوْم"، لِلسَّائِلِ وَالْمَحْرُوْمِ.(سورة المعارج أية 24-25)

"and those in whose riches there is a specefied right[24] for the one who asks and the one who is deprived,[25]" (70:24-25)

In certain verses, this right has been defined as the right of Allah. For example:

وآتوا حَقَّهُ يَومَ حَصَادِهِ (سورة الأنعام أية 142)

"and pay its due on the day of harvest" (6:142)

The word "right" and "due" in these verses makes it clear that participation in the process of production is not the only source of the right to ''wealth'',

and that the needy and the poor have as good a right to "wealth" as its primary owners. Thus Islam proposes to distribute wealth in such a manner that all those who have taken part in production should receive the reward for their contribution to the production of wealth, and then all those too should receive their share that Allah has given a right to "wealth".

c) Eradicating the concentration of wealth

The third object of the distribution of wealth, which Islam considers to be very important, is that wealth, instead of being concentrated in a few hands, should be allowed to circulate in the society as widely as possible, so that the distinction between the rich and the poor should be narrowed down as far as is natural and practicable. The attitude of Islam in this respect is that it has not permitted any individual or group to have a monopoly over the primary sources of wealth, but has given every member of the society an equal right to derive benefit from them. Mines, forests, un-owned barren lands, hunting and fishing, wild grass, rivers, seas, spoils of war etc., all these are primary sources of wealth. With respect to them, every individual is entitled to make use of them according to his abilities and his labor without anyone being allowed to have any kind of monopoly over them.

كَيْ لَا يَكُونَ دُولَةً بَيْنَ الْأَغْنِيَاءِ مِنكُم (سورة الحشر أية 7)

"So that this wealth should not become confined only to the rich amongst you". (59:7)

Beyond this, wherever human intervention is needed for the production of wealth and man produces some kind of wealth by deploying his resources and labor, Islam gives due consideration to the resources and labor thus deployed, and recognizes man's right of property in the wealth produced. Every one shall get his share according to the labor and resources invested by him. Says the Holy Quran:

"We have allocated among them their livelihood in the worldly life, and have raised some of them over others in ranks, so that some of them may put some others to work." (43:32)

But, in spite of this difference among social degrees or ranks certain injunctions have been laid down in order to keep this distinction within such limits as are necessary for the establishment of a practicable system of economy, so that wealth should not become concentrated in a few hands.

Of these three objects of the distribution of wealth, the first distinguishes Islamic economy from Socialism, the third from Capitalism, and the second from both at the same time.

Chapter 4

Prohibition Of Riba In Qur'an And Hadith

Riba was not prohibited abruptly. Its prohibition was rather in a gradual manner. Four verses that were revealed in order to prohibit riba gradually are stated in the following lines as per the sequence of their revelation.

1. First Revelation (Surah al-Rum, verse 39)

"وَمَا اٰتَيْتُمْ مِنْ رِّبًا لِّيَرْبُوَا فِيْ اَمْوَالِ النَّاسِ فَلاَ يَرْبُوْا عِنْدَ اللّٰه وَمَا اٰتَيْتُمْ مِنْ زَكٰوةٍ تُرِيْدُوْنَ وَجْهَ اللّٰهِ فَاُوْلٰائِكَ هُمُ الْمُضْعِفُوْنَ".

"Whatever Riba (increased amount) you give, so that it may increase in the wealth of the people, it does not increase with Allah; and whatever zakah you give, seeking Allah's pleasure with it, (it is multiplied by Allah, and) it is such people who multiply (their wealth in real terms)." (30: 39)

- This Surah was revealed in Makkah.

- This verse does not prohibit riba, as explained by some commentators of the Holy Quran. But it simply says that riba does not increase with Allah and it does not carry any reward in the hereafter. On the other hand, giving out charity is a greater gesture that Allah appreciates.

- In this verse word Riba does not mean interest or usury. But word riba here means a gift offered by someone to a person with the intention that the latter will give a greater gift or greater benefit to the former.

- If the word riba is taken to mean usury than there is no specific prohibition against it in the verse.

- However there is subtle indication to the fact that Allah does not favor this practice.

2. Second Revelation (Surah al-Nisa', verse 161)

"وَاَخْذِهِمُ الرِّبَا وَقَدْ نُهوْا عَنْهُ وَأَكْلِهِمْ أَمْوَالَ النَّاسِ بِالْبَاطِلِ وَاَعْتَدْنَا لِلْكٰفِرِيْنَ مِنْهُمْ عَذَابًا اَلِيْمًا"

"And for their charging Riba (usury or interest) while they were forbidden from it; and for their devouring of the properties of the people by false means. We have prepared, for the disbelievers among them, a painful punishment. (4: 161)"

- The ayah was revealed before 4th year of Hijra. It was revealed in answer to the argumentation of the Jews who came to the Holy Prophet

and asked him to bring down a book from heavens like the one given to them by Prophet Musa (AS)

- Riba in this verse, undoubtedly, refers to usury or interest

- It lists evil deeds of Jews and mentions that they used to take Riba, which was prohibited for them, but in this verse we cannot ascertain that it was also prohibitive for Muslims.

- But we can infer that it would be a sinful act for the Muslims as well otherwise they had no reason to blame the Jews for this practice so prohibition of riba for Muslims is still not explicitly mentioned in the verse.

3. Third Revelation (Surah Al 'Imran, verses 130-132)

"يَا اَيُّهَا الذِيْنَ آمَنُوْا لاَ تَأكُلُوْا الرِّبَا اَضْعَافًا مُضَاعَفَةً وَاتَّقُوْا اللّٰهَ لَعَلَّكُمْ تُفْلِحُوْنَ ،
وَاتَّقُوْا النَّارَ الَّتِيْ اُعِدَّتْ لِلكٰفِرِيْنَ-وَاَطِيعُوا اللّٰهَ وَالرَّسُوْلَ لَعَلَّكُمْ تُرْحَمُوْنَ"

"O you believe, do not eat up the amounts acquired through Riba (interest), doubled and multiplied. Fear Allah, so that you may be successful, [130] and fear the fire that has been prepared for the disbelievers. [131] Obey Allah and the Messenger, so that you may be blessed. [132]"

- This verse was revealed sometime in the 2nd year after Hijra. As it was revealed somewhere around the time of battle of Uhud which took place in the 2nd year after Hijra.

- This verse clearly prohibits the practice of Riba for the Muslims.

- The reason behind this verse's revelation was that the invaders of Makkah had financed their army by taking usurious loans to arrange arms against Muslims and it was feared that Muslims might follow the same practice so in order to prevent Muslims from this approach this verse was revealed.

4. Fourth Revelation (Surah al-Baqarah, verses 275-281)

اَلَّذِيْنَ يَأكُلُوْنَ الرِّبَا لاَ يَقُوْمُوْنَ اِلاَّ كَمَا يَقُوْمُ الَّذِيْ يتَخَبَّطُهُ الشَّيْطَانُ مِنَ المَسِّ ذٰلِكَ بِأَنَّهُمْ قَالُوْا اِنَّمَا الْبَيْعُ مِثْلُ الرِّبَا ، وَاَحَلَّ اللّٰه الْبَيعَ وَحَرَّمَ الرِّبَا،فَمَنْ جَآ ءَ هُ مَوْعِظَةٌ مِن رَّبِّهِ فَانْتَهَي فَلَهُ مَا سَلَفَ وَاَمْرُهُ اِلَيَ اللّٰه وَمَنْ عَادَ فَاؤُلائك اَصْحَابُ النَّارِ هُمْ فِيْهَا خلدون،يَمْحَقُ اللّٰهُ الرِّبَا وَيُرْبِي الصَّدَقَات وَاللّٰه لاَ يُحِبُّ كُلَّ كَفَّارٍ اَثِيْم ،اِنَّ الَّذِيْنَ آمَنُوْا وَعَمِلُوْا الصَّالِحَاتِ وَ اَقَامُوا الصَّلٰوةَ وَاٰ تُو الزَّكٰوةَ لَهُمْ أَجْرُهُمْ عِنْدَ رَبِّهِمْ وَلاَ خَوْفٌ عَلَيْهِمْ وَلاَ هُمْ يَحْزَنُوْن ،يَا اَيُّهَا الَّذِيْنَ اٰمَنُوا ا تَّقُوْا اللّٰه وَذَرُوْا مَا بَقِيَ مِنَ الرِّبَا اِنْ كُنْتُمْ مُؤْمِنِيْن ،فَاِنْ لَّمْ تَفْعَلُوْا فَأْذَنُوْا بِحَرْبٍ مِنَ اللّٰهِ وَرَسُوْلِهِ ،وَاِنْ تُبْتُمْ فَلَكُمْ رُؤُوسُ أَمْوَالِكُمْ لاَ تَظْلِمُوْنَ وَلاَ تُظْلَمُوْنَ ،وَاِنْ كَانَ ذُوْ عُسْرَةٍ فَنَظِرَةٌ اِلَيٰ مَيْسَرَة وَاَنْ تَصَدَّقُوْا خَيْرٌ لَكُمْ اِنْ كُنْتُمْ تَعْلَمُوْنَ ،وَاتَّقُوْا يَوْمًا تُرْجَعُوْنَ فِيهِ اِلَيَ اللّٰهِ ، ثُمَّ تُوَفَّي كلُّ نَفْسٍ مَّا كَسَبَتْ وَهُمْ لاَ يُظْلَمُوْنَ.

"Those who take riba (usury or interest) will not stand but as stands the one whom the demon has driven crazy by his touch. That is because they have said:"Sale is but like riba", while Allah has permitted sale, and prohibited

riba. So, whoever receives an advice from his Lord and desists (from indulging in riba), then what has passed is allowed for him, and his matter is up to Allah. As for the ones who revert back, those are the people of Fire. There they will remain forever. [275]

Allah destroys riba and nourishes charities, and Allah does not like any sinful disbeliever. [276]

Surely those who believe and do good deeds, and establish Salah(prayer) and pay Zakah will have their reward with their Lord, and there is no fear for them, nor shall they grieve.[277]

O you, who believe, fear Allah and give up what still remains of riba, if you are believers. [278]

But if you do not (give it up), then listen to the declaration of war from Allah and His Messenger. However, if you repent, yours is your principal. Neither wrong, nor be wronged. [279]

If there is one in misery, then (the creditor should allow) deferment till (his) ease, and that you forgo it as alms is much better for you, if you really know. [280]

Be fearful of a day when you shall be returned to Allah, then every person shall be paid, in full, what he has earned, and they shall not be wronged. [281]

- These verses elaborate the severity of the prohibition of Riba.

- After the victory of Makkah, Holy Prophet ﷺ declared as void all the amounts of Riba that were due at that time.

- Tribe of Thaqif who were the inhabitants of Taaif came to Holy Prophet ﷺ and embraced Islam and also entered into a treaty with him inn which they signified that all the riba payable by tribe of Thaqif will be void but the amount of Riba that is to be received by the people of Thaqif will not be void.

- The Holy Prophet ﷺ instead of signing the treaty simply wrote a sentence that Banu- Thaqif will have the same rights as the Muslims have.

- Banu Ibn-al-Mughirah declined to pay interest on the ground that Riba was prohibited in Islam. Matter was placed before the Holy Prophet ﷺ on which the holy verse was revealed and Banu-Thaqif surrendered and said we have no power to wage war against Allah.

Prohibition Of Riba In Hadith

A. General

1.

"عن جابر رضي الله عنه قال:لعن رسول الله صلي الله عليه وسلم آكل الربا وموكله وكاتبه شاهديه وقال هم سواء"(رواه مسلم، باب لعن اكل الربا وموكله، وكذا في الترمذي بمعناه)

Narrated by Jabir": The Prophet ﷺ cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said: "They are all alike [in guilt]."

2.

"وربا الجاهلية موضوع وأوّل ربا أضع ربانا ربا عباس بن عبد المطلب فإنه موضوع كلّه"(رواه مسلم في كتاب الحج، باب حجة النبيﷺ، وكذا في مسند أحمد بمعناه)

Jabir ibn 'Abdallah رضی اللہ تعالی عنہ", giving a report on the Prophet's ﷺ Farewell Pilgrimage, said: The Prophet ﷺ, addressed the people and said "All of the riba of Jahiliyyah is annulled. The first riba that I annul is our riba, that accruing to 'Abbas ibn 'Abd al-Muttalib [the Prophet's ﷺ uncle]; it is being cancelled completely."

3.

"عن عبد الله بن حنظلة غسيل الملائكة قال : قال رسول الله صلي الله عليه وسلم :درهم ربوا يأكله الرجل وهو يعلم أشدّ من ستة وثلثين زنيةً -رواه أحمد والدار قطني- وروي البيهقي في شعب الايمان عن ابن عباس وزاد وقال :من نبت لحمه من السحت فالنّار أولي به-"(مشكوٰة المصابيح، كتاب البيوع، باب الربا)

Narrated by 'Abdallah ibn Hanzalah رضی اللہ تعالی عنہ",: The Prophet ﷺ,said: "A dirham of riba which a man receives knowingly is worse than committing adultery thirty-six times" (narrated in Musnad-e-Ahmed and Ad-Daruqutni). Bayhaqi has also reported the above hadith in Shu'ab al-iman with the addition that "Hell befits him whose flesh has been nourished by the unlawful."

4.

"عَن أَبِي هُرَيرَةَ قَالَ قَالَ رسول الله صلي الله عليه وسلم أَتَيتُ لَيلَةَ أُسرِيَ بِي عَلَي قَومٍ بُطُونُهُم كَالبُيُوتِ فِيهَا الحَيَّاتُ تُرَي مِن خَارِجِ بُطُونِهِم فَقُلتُ مَن هَؤُلَاءِ يَا جِبرَائِيلُ قَالَ هَؤُلَاءِ أَكَلَةُ الرِّبَا"(رواه ابن ماجة، كتاب التجارة، باب التغليظ في الربا)

Narrated by Abu Hurayrah رضی اللہ تعالی عنہ, The Prophet ﷺ said: "On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received interest."

5.

"عن أبي هريرة رضي الله عنه قال:قال رسول اللّه صلي اللّه عليه وسلم:الربوا سبعون حوباً أيسرها أن ينكح الرجل امّه -"(رواه ابن ماجة، كتاب التجارة، باب التغليظ في الربا)

Narrated by Abu Hurayrah رضی اللہ تعالی عنہ, The Prophet ﷺ said: "Riba has seventy segments, the least serious being equivalent to a man committing adultery with his own mother."

6.

"عن أبي هريرة رضي الله عنه قال:قال رسول اللّه صلي اللّه عليه وسلم:ليأتين علي النّاس زمان لا يبقي منهم احد إلاّ أكل الربا فإن لم يأكله أصابه من بخاره، قال ابن عيسي أصابه من غباره "-(رواه ابوداود،كتاب البيوع، باب في اجتناب الشبهات، وكذا في ابن ماجة بمعناه)

Narrated by Abu Hurayrah رضی اللہ تعالی عنہ The Prophet ﷺ said: "There will certainly come a time for mankind when everyone will take riba and if he does not do so, its dust will reach him."

7.

"عن ابي هريرة رضي الله عنه قال:قال رسول اللّه صلي اللّه عليه وسلم:اربعة حق علي اللّه ان لا يدخلهم الجنّة ولا يذيقهم نعيمها: مدمن الخمر، وآكل الربا، وآكل مال اليتيم بغير حق ، والعاق لوالديه"(رواه المستدرك للحاكم في كتاب البيوع)

Narrated by Abu Hurayrah رضی اللہ تعالی عنہ The Prophet ﷺ said: "Allah would be justified in not allowing four persons to enter paradise or to taste its blessings: he who drinks habitually, he who takes riba, he who usurps an orphan's property without right, and he who is undutiful to his parents."

B. Riba an Nasiyah

1.

"لا ربـا إلاّ في النّسيئة-" [الجامع الصحيح للبخاري، كتاب البيوع، باب بيع الدينار بالدينار نساءً]

Narrated by Usamah ibn Zayd رضی اللہ تعالی عنہ The Prophet ﷺ said: "There is no riba except in Nasiyah [Deferment]."
In another narration:

لا ربا فيما كان يداً بيدٍ-(الصحيح لمسلم كتاب المساقاة، باب الطعام مثلاً بمثلٍ)

"There is no riba in hand-to-hand [spot] transactions."

2.

عن ابن مسعود رضي الله عنه قال : قال رسول اللّه صلي اللّه عليه وسلم:إنّ الربوا وإن كثر فإن عاقبته تصير الي قل- رواه أحمد -"

Narrated by Abdullah Ibn Mas'ud رضی اللہ تعالی عنہ The Prophet ﷺ said: "Even when interest is much, it is bound to end up into paltriness."

3.

"عن انس قال : قال رسول الله صلي الله عليه وسلم : إذا اقرض احدكم قرضا فأهدي إليه طبقا فلا يقبله أو حَمَلَه علي دابة فلا يَرْكَبْهَا إلا ان يكون بينه وبينه قبل ذلك."(السنن الكبري للبيهقي، كتاب البيوع، باب كل قرض جر منفعة فهو ربا)

Narrated by Anas ibn Malik ﵁ The Prophet ﷺ said: "When one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually."

4.

"عن انس رضي الله عنه عن النبي صلي الله عليه وسلم اذا اقرض الرجل فلا يأخذ هدية- رواه البخاري في
تاريخه هكذا في المنتقي" -(مشكوٰة المصابيح، باب الربوٰ)

Narrated by Anas ibn Malik ﵁ The Prophet ﷺ said: "If a man extends a loan to someone he should not accept a gift."

5.

"عن أبي بردة بن أبي موسي قال : قدمت المدينة فلقيت عبد الله بن سلام فقال : إنَّكَ بِأرضِ الرِّبَا بِهَا فَاشٍ إذا كانَ لكَ عَلي رَجُلٍ حَقٌّ فَأهدَي إلَيكَ حِملَ تِبنٍ أو حِملَ شَعِيرٍ أو حِملَ قتٍّ فَلَا تَأخُذهُ فَإنَّهُ رِبًا[رواه البخارى باب مناقب عبد الله بن السلام]

From Abu Burdah ibn Abi Musa ﵁ I came to Madinah and met 'Abdallah ibn Salam who said, "You live in a country where riba is rampant; hence if anyone owes you something and presents you with a load of hay, or a load of barley, or a rope of straw, do not accept it for it is riba."

6.

"عن فضالة بن عبيد كل قرض جرّ منفعة فهو وجه من وجو ه الربا "(رواه البيهقي في السنن الكبري)

Fadalah ibn 'Ubayd said that "The benefit derived from any loan is one of the different aspects of riba." This hadith is mawquf implying that it is not necessarily from the Prophet; it could be an explanation provided by Fadalah himself, a companion of the Prophet ﷺ

C. Riba al-Fadl

1.

"الذهب بالذهب مثلا بمثل والفضة بالفضة مثلا بمثل والتمر بالتمر مثلا بمثل والبر بالبر مثلا بمثل والملح بالملح مثلا بمثل والشعير بالشعير مثلا بمثل فمن زاد او ازداد فقد اربي ، بيعوا الذهب بالفضة كيف شئتم يدًا بيدوبيعوا الشعير بالتمر كيف شئتم يدًا بيد"[كنز العمال-٩٧٩٦]

The Prophet ﷺ said, "Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates,

sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, but if a person transacts in excess, it will be usury (riba). However, sell gold for silver anyway you please on the condition it is hand-to-hand (spot) and sell barley for date anyway you please on the condition it is hand-to-hand (spot)."

2.

"عن عبادة بن الصامت رضي الله عنه قال : قال رسول الله صلي الله عليه وسلم : الذهب بالذهب والفضة بالفضة والبر بالبر والشعير بالشعير والتمر بالتمر،والملح بالملح مثلا بمثل سواء بسواء يدا بيدفاذا اختلفت هذه الأصناف فبيعوا كيف شئتم اذا كان يدا بيد"-(رواه مسلم،كتاب المساقاة، باب الصرف و بيع الذهب بالورق نقداً، وكذا في الترمذى بمعناه)

From 'Ubada ibn al-Samit رضی اللہ تعالیٰ عنہ The Prophet ﷺ said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand."

3.

"عن أبي سعيد الخدري رضي الله عنه قال : قال رسول الله صلي الله عليه وسلم الذهب بالذهب والفضة بالفضة والبر بالبر والشعير بالشعير والتمر بالتمر والملح بالملح مثل بمثل يدا بيد فمن زاد او استزاد فقد أربي- الآخذ والمعطي فيه سواء"- [رواه مسلم كتاب المساقاة، باب الصرف و بيع الذهب بالورق نقداً،وكذا في مسند أحمد بمعناه]

Narrated by Abu Sa'id al-Khudri رضی اللہ تعالیٰ عنہ The Prophet ﷺ said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, and hand-to-hand. Whoever pays more or takes more has indulged in riba. The taker and the giver are alike [in guilt]."

4.

"عن أبي سعيد وأبي هريرة رضي الله عنه ان رسول الله صلي الله عليه وسلم استعمل رجلا علي خيبر فجاءه بتمر جنيب فقال : اكل تمر خيبر هكذا؟ قال : لا والله يا رسول الله ! إنا لنأخذ الصاع من هذا بالصاعين ، والصاعين بالثلاثة فقال : لا تفعل، بع الجمع بالدراهم ثم ابتع بالدراهم جينبا وقال في الميزان مثل ذلك"[رواه الجامع الصحيح للبخاري في باب الوكالة في الصرف والميزان،و مسلم في باب بيع الطعام مثلاً بمثلٍ]

Narrated by Abu Sa'id رضی اللہ تعالیٰ عنہ and Abu Hurayrah رضی اللہ تعالیٰ عنہ man employed by the Prophet ﷺ in Khaybar brought for him janeeb [dates of very fine quality]. The Prophet ﷺ asked him, "Are all the dates of Khayber like that?" The man replied, "No, I swear Allah, O Prophet of Allah, We exchange one sa' [a measure] of this kind of dates for two or three [of the other kind of dates]". The Prophet ﷺ replied, "Do not do so. Sell all the dates (no matter they are of fine quality or not) for darahim and then use the darahim to buy janeeb. And the Prophet ﷺ then said that the ruling of the things that are exchanged through balance is same as that.

5.

"عن ابي سعيدرضي الله عنه قال :قال جاء بلال الي النبي صلي الله عليه وسلم بتمر برني فقال له النبي صلي الله عليه وسلم : من أين هذا؟ قال : كان عندنا تمر ردي فبعت منه صاعين بصاع فقال : أوّه عين الربا ، عين الربا لاتفعل ولكن إذا أردت أن تشتري فبع التمر ببيع آخر ثم اشتره."(في مشكوة المصابيح، باب الربوا، الفصل الأوّل، متفق عليه)

Narrated by Abu Sa'id ": Bilal brought to the Prophet some barni [good quality] dates whereupon the Prophet asked him where these were from. Bilal replied, "I had some inferior dates which I exchanged for these - two sa's for a sa'." The Prophet said, "Oh no, this is exactly riba. Do not do so, but when you wish to buy, sell the inferior dates against something [cash] and then buy the better dates with the price you receive."

6.

عن فضالة بن عبيد قال : اشتريت يوم خيبر قلادة باثني عشر دينارا فيها ذهب وخرز ففصلتها فوجدت فيها اكثر من اثني عشر دينارا فذكرت ذلك للنبي صلي الله عليه وسلم فقال : لا تباع حتي تفصّل" .[رواه مسلم في باب بيع القلادة فيها خرز وذهب، وأبو داود في باب في حلية السيف تباع بالدراهم، والترمذي في باب ما جاء في شراء القلادة وفيها ذهب وخرز، والنسائي في باب بيع القلادة فيها خرز وذهب]

Narrated by Fadalah ibn 'Ubayd al-Ansari " : On the day of Khaybar I bought a necklace of gold and pearls for twelve dinars. On separating the two, I found that the gold itself was equal to more than twelve dinars. So I mentioned this to the Prophet who replied, "It [jewellery] must not be sold until the contents have been valued separately."

7.

"عن ابي امامة رضي الله تعالي عنه عن النبي صلي الله عليه وسلم قال : من شفع لأخيه بشفاعة فأهدي له هدية عليها فقبلها ، فقد اتي بابا عظيما من ابواب الربا."(رواه أبو داود في باب في الهدية لقضاء الحاجة)

Narrated by Abu Umamah : The Prophet said: "Whoever makes a recommendation for his brother and accepts a gift offered by him has entered in one of the lagest gates of riba."

8.

"عن انس غبن المسترسل ربا". (الجامع الصغير للسيوطي تحت المادّة 'غبن'، كنز العمّال في كتاب البيوع الباب الثاني الفصل الثاني، وكذا في السنن الكبري' للبيهقي)

Narrated by Anas ibn Malik : The Prophet said: "Deceiving a mustarsal [an unknowing entrant into the market] is riba."

9.

عن عبدالله بن أبي أوفيٰ : قال رسول الله صلي الله عليه وسلم : الناجشُ آكل رباً خائن.(رواه البخاري في كتاب الشهادات، باب قول الله تعاليٰ: انّ الذين يشترون بعهد الله ثمناًقليلاً)

Narrated by 'Abdallah ibn Abi Awfa رضی اللہ تعالیٰ عنہ : The Prophet ﷺ said: "A najish [one who serves as an agent to bid up the price in an auction] is a taker of riba, a treacherous."

Riba And Its Types

Definition of Riba (Interest)

The word "Riba" means excess, increase or addition. According to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money).

This definition of Riba is derived from the Quran and is unanimously accepted by all Islamic scholars.

Classification of RIBA

There are two types of Riba, identified to date by these scholars namely 'Riba An Nasiyah' and 'Riba Al Fadl'.

Riba An Nasiyah

'Riba An Nasiyah' is defined as excess, which results from predetermined interest (sood) which a lender receives over and above the principle (Ras ul Maal)

This is the real and primary form of Riba. Since the verses of Quran has directly rendered this type of Riba as haram, it is called Riba Al Quran. Similarly since only this type was considered Riba in the dark ages, it has earned the name of Riba Al Jahiliyyah.

The meaning of Riba has been clarified in the following verses of Quran:

"يَا اَيُّهَا الَّذِيْنَ اٰمَنُوا ا تَّقوْا الله وَذَرُوْا مَا بَقِيَ مِنَ الرِّبَا اِنْ كُنْتُمْ مُؤْمِنِيْن ،فَاِنْ لَّمْ تَفْعَلُوْا فَأذَنُوْا بِحَرْبٍ مِنَ اللّه وَرَسُوْلِهِ،وَاِنْ تُبْتُمْ فَلَكُمْ رُؤُوْسُ اَمْوَالِكُمْ لاَ تَظْلِمُوْنَ وَلاَ تُظْلَمُوْنَ، وَاِنْ كَانَ ذُوْ عُسْرَةٍ فَنَظِرَةٌ اِلَيٰ مَيْسَرَة وَأَنْ تَصَدَّقُوْا خَيْرٌ لَكُمْ اِنْ كُنْتُمْ تَعْلَمُوْن ،وَاتَّقُوْا يَوْمًا تُرْجَعُوْنَ فِيْهِ اِلَيَ اللّه ، ثُمَّ تُوَفَّي كلُّ نَفْسٍ مَّا كَسَبَتْ وَهُمْ لاَ يُظْلَمُوْن " (سورة البقرة, أية 278-281)

"O you who believe, fear Allah and give up what still remains of riba, if you are believers.[278]But if you do not (give it up), then listen to the declaration of war from Allah and His Messenger.[279]However, if you repent, yours is your principal. Neither wrong, nor be wronged.[279] If there is one in misery, then (the creditor should allow) deferment till (his) ease, and that you forgo it as alms is much better for you, if you really know.[280] Be fearful of a day when you shall be returned to Allah, then every person shall be paid, in full, what he has earned, and they shall not be wronged. [281]

These verses clearly indicate that the term Riba means any excess compensation over and above the principal which is without due consideration. However, the Quran has not altogether forbidden all types of excess; as it

Chapter 5

Riba And Its Types

Definition of Riba (Interest)

The word "Riba" means excess, increase or addition. According to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money).

This definition of Riba is derived from the Quran and is unanimously accepted by all Islamic scholars.

Classification of RIBA

There are two types of Riba, identified to date by these scholars namely 'Riba An Nasiyah' and 'Riba Al Fadl'.

Riba An Nasiyah

'Riba An Nasiyah' is defined as excess, which results from predetermined interest (sood) which a lender receives over and above the principle (Ras ul Maal)

This is the real and primary form of Riba. Since the verses of Quran has directly rendered this type of Riba as haram, it is called Riba Al Quran. Similarly since only this type was considered Riba in the dark ages, it has earned the name of Riba Al Jahiliyyah.

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"O you who believe, fear Allah and give up what still remains of riba, if you are believers.[278]But if you do not (give it up), then listen to the declaration of war from Allah and His Messenger.[279]However, if you repent, yours is your principal. Neither wrong, nor be wronged.[279] If there is one in misery, then (the creditor should allow) deferment till (his) ease, and that you forgo it as alms is much better for you, if you really know.[280] Be fearful of a day when you shall be returned to Allah, then every person shall be paid, in full, what he has earned, and they shall not be wronged. [281]

These verses clearly indicate that the term Riba means any excess compensation over and above the principal which is without due consideration. However, the Quran has not altogether forbidden all types of excess; as it

is present in trade as well, which is permissible. The excess that has been rendered haram in Quran is a special type termed as Riba. In the dark ages, the Arabs used to accept Riba as a type of sale, which mistakenly is also being understood in the present era as well. Islam has categorically made a clear distinction between the excess in capital resulting from sale and excess resulting from interest. The first type of excess is permissible but the second type is forbidden and rendered Haram.

"ذٰلِك بِأَنَّـهُمْ قَالُوْا اِنَّمَا الْبَيْعُ مِثْلُ الرِّبَا، وَاَحَلَّ الله الْبَيْعَ وَحَرَّمَ الرِّبَا" (سورة البقرة , أية 275)

"That is because they have said:"Sale is but like riba", while Allah has permitted sale, and prohibited riba.(2:275)

Imam Abu Bakr Jassas Razi رحمة اللّٰه عليه has outlined a comprehensive legal definition of Riba An Nasiyah in the following words:

"هو القرض المشروط فيه الأجل وزيادة مال علي المستقرض."(أحكام القران)

"That kind of loan where specified repayment period and an amount in excess of capital is predetermined."

One of the ahadith quoted by Ali ibn Abi Talib رضی اللہ تعالیٰ عنہ says:

"عن عمارة الهمداني قال سمعت عليّا يقول قال رسول الله صلي الله عليه وسلم كلّ قرض جر منفعة فهو ربا"(مسند الحارث / زوائد الهيثمي ٥٠٠/١)

Ali Ibn Abi Talib رضی narrated that the Holy Prophet ﷺ said, "Every loan that draws interest is Riba."

The famous Sahabi Fazala Bin Obaid رضی اللہ تعالیٰ عنہ has also defined Riba in similar words:

عن فضالة بن عبيد صاحب النبي صلي الله عليه وسلم انه قال كل قرض جر منفعة فهو وجه من وجوه الربا(السنن الكبريٰ للبيهقي)

"Every loan that draws profit is one of the forms of Riba"

The famous Arab scholar Abu Ishaq az Zajjaj رحمة اللّٰه عليه also defines Riba in the following words:

"كل قرض يؤخذ به أكثر منه"

"Every loan that draws more than its actual amount"

Riba An Nasiyah refers to the addition of the premium which is paid to the lender in return for his waiting as a condition for the loan and is technically the same as interest. The prohibition of Riba An Nasiyah is one of those issues which have been confirmed in the revealed laws of all Prophets علیہ سلام Some of the old testaments has rendered Riba as haram

(See Exodus 22:25, Leviticus 25:35-36, Deutronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12). The Quran has also stated the prohibition of Riba in various verses and has warned those who persist in practicing it of a war which is certain to be declared on them by Allah Himself and His messenger and has seriously threatened those engaged as writer, witness and dealer in Riba transactions. These verses and ahadith will be are discussed at length in a separate chapter 4 of this book.

According to the above definition of Riba An Nasiyah, the giving and taking paying and receiving of any excess amount in exchange of a loan at an agreed rate is included in interest irrespective whether regardless of its being at a high or low rate. It has been proven through ahadith that the Holy Prophet ﷺ paid excess at the loan repayment time but since this excess was not paid through an agreed rate, it cannot be called interest. This clarifies that the word "draws" in the hadith definition "Every loan that draws interest is Riba." has been used to highlight the giving and taking paying and receiving of excess amount , as a pre agreed term/condition in the loan contract. Due to this, Imam Abu Bakr Jassasرحمة الله عليه has added the word "pre-determined" to the definition. The fact that Riba An Nasiyah is categorically haram has never been disputed in the Muslim community.

In short, the Riba interest of today which is supposed to be the pivot of human economy and features in discussions on the problem of interest is nothing but this Riba, whose unlawfulness in terms of Shariah the unlawfulness of which stands is proved on the authority of the seven verses of the Quran, of more than forty ahadith and of the consensus of the Muslim community.

Wisdom behind the prohibition of Riba An Nasiyah. Although no specific reason has been pointed out in the Holy Quran or in the narration of the Holy Prophet for the impressibility of Riba however various malfunctions are apparent as a result of indulgence in Riba based activities, which are as follows:

First of all, we should realize that there is nothing in the entire creation of the world, which has no goodness or utility at all. But it is commonly recognized in every religion and community that things which have more benefits and less harms are called beneficial and useful. Conversely, things that cause more harm and less benefits are taken to be harmful and useless. Even the noble Quran, while declaring liquor and gambling to be haram, proclaimed that they do hold some benefits for people but the curse of sins they generate is far greater than the benefits they yield. Therefore, these cannot be called good or useful; on the contrary, taking these to be acutely harmful and destructive,. It is necessary that they be avoided.

The case of Riba An Nasiyah is not different. Here the consumer of Riba does have some casual and transitory profits apparently coming to him, but its curse in this world and in the Hereafter is much too severe as compared

to this benefit. Those who indulge in Riba suffer such a spiritual and moral loss that it virtually takes away the great quality of being 'human' from him. An intelligent person who compares things in terms of their profit and loss, harm and benefit can hardly include things of casual benefit with an everlasting loss in the list of useful things. Similarly no sane and just person will say that personal and individual gain which causes loss to the whole community or group is useful. In theft and robbery for example, the gain of the gangster and the take of the thief is all too obvious but it is certainly harmful for the entire community since it ruins its peace and sense of security.

Riba Al Fadl

The second classification of Riba is Riba Al Fadl. Since the prohibition of this Riba has been established on the basis of Sunnah, it is also called Riba Al Hadees.

Riba Al Fadl actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand-to-hand purchase & sale as explained in the famous hadith:

"الذهب بالذهب مثلا بمثل والفضة بالفضة مثلا بمثل والتمر بالتمر مثلا بمثل والبر بالبر مثلا بمثل والملح بالملح مثلا بمثل والشعير بالشعير مثلا بمثل فمن زاد او ازداد فقد اربي ، بيعوا الذهب بالفضة كيف شئتم يدًا بيد.وبيعوا الشعير بالتمر كيف شئتم يدًا بيد"[كنز العمال.٤٦٦٩]

The Prophet ﷺ said, "Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dates in exchange of equivalent dates, sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, but if a person transacts in excess, it will be usury (Riba). However, sell gold for silver anyway you please on the condition it is hand-to-hand (spot) and sell barley for date anyway you please on the condition it is hand-to-hand (spot)."

Amwaal-e-Ribawiyyah

This hadith enumerates 6 different commodities namely:

1) Gold
2) Silver
3) Dates
4) Wheat
5) Salt
6) Barley

These six commodities can only be bought and sold in equal quantities and on spot. An unequal sale or a deferred sale of these commodities with similar commodities will constitute Riba. These six commodities in fiqh terminology are called "Amwaal-e-Ribawiyyah". Does this hadith apply only to

the items mentioned in it? Does it concern sales of barley or wheat but not rice? Of dates but not raisins? A complete legal definition differs in every fiqh. Scholars such as Taoos and Qatada hold that Riba Al Fadl includes these specified types only, however a majority of Islamic scholars believe that some other commodities should also be included. In order to determine other commodities that are to be included in the Amwaal-e-Ribawiyyah some fiqhs hold that the characteristics which are common amongst these items can be used as basis illat (Parenthesis)for Riba Al Fadl. An illat is the attribute of an event that entails a particular divine ruling in all cases possessing that attribute; it is the basis for applying analogy. Ribawi goods are therefore goods that exhibit one of the efficient causes that results in the activation of rules of Riba. Various schools define these causes differently:

Imam Abu Hanifa رحمة اللّٰه عليه

Imam Abu Hanifa رحمة اللّٰه عليه sees only two common characteristics namely:

1) Weight or Volume
2) Exchange is between similar commodities

Meaning all these six goods are sold by either weight or volume. Therefore all those commodities, which are measured through either the units of weight or the units of volume and are exchanges against the same commodity will fall under the rules of Riba Al Fadl.

Imam Shafi رحمة اللّٰه عليه

The two characteristics observed by Imam Shafi رحمة اللّٰه عليه are:

1) Medium of Exchange or
2) Eatable

Therefore this law will apply on everything edible or having the natural ability of becoming a medium of exchange (currency).

Imam Maalik رحمة اللّٰه عليه

Imam Maalik رحمة اللّٰه عليه identified the following two characteristics:

1) Eatables and
2) Preservable

Imam Ahmad Bin Hanbal رحمة اللّٰه عليه

Three citations have been related to him:

i) First citation conforms to the opinion of Imam Abu Hanifa رحمة اللّٰه عليه
ii) Second citation conforms to the opinion of Imam Shafai رحمة اللّٰه عليه
iii) Third citation includes three characteristics at the same time namely

edible, weight and volume.

However, all schools of thought are unanimous that if one of the two characteristics are found then tafazul i.e. difference in quantity is allowed but Nasiyah i.e. credit / deferred sale is not allowed.

Wisdom behind the prohibition of Riba Al Fadl

The prohibition of Riba Al Fadl is intended to ensure justice and remove all forms of exploitation through 'unfair' exchanges and to close all back-doors to Riba An Nasiyah because in the Islamic Shariah, anything that serves as a means to the unlawful is also unlawful.

The laws of Riba Al Fadl

After closely analyzing the meaning and interpretation of the above ahadith and their explanation in further ahadith along with issues raised in reference work of Hanafi fiqh, the following rules and laws governing Riba Al Fadl are derived:

1. It is evident that the exchange of homogeneous commodities will only be required if they differ in quality and characteristic e.g. different genus of rice and wheat, superior quality gold and inferior quality gold, mineral salt and sea salt etc. The exchange of any of these six commodities with itself, but differing in types/quality (which is called barter in modern terminology), even when considering market rate, is prohibited in unequal amount. The reason being that by exchanging these commodities in unequal amounts there is a fear of developing the rationale in a person eventually leading to interest (sood) based earnings and illegal benefits. Such transactions might also lead to defrauding. As a step to prevent this state, the Shariah has made it a law that exchange of any of these six commodities with itself but differing in quality, is allowed in only one of the following forms:

   a) Any difference in value/quality should be ignored and the commodities should be exchanged in equal amounts (equal weight and volume).

   b) Instead of direct exchange of commodities of the same kind, a person should sell his commodity against cash at the market value and buy someone else's commodity in exchange of cash proceeds at the market value.

2. One of the ways of transacting commodities of the same kind is that a person has a raw material and someone else has a product made of that material and both decide to exchange their product. In this case, one has to see whether:

   a) The characteristics of this product has been totally changed by the industry: For e.g. the remarkable changes that transform raw cotton

into cloth or iron into machinery. In this case, it is permissible to transact lesser amount of cloth against greater amount of raw cotton or raw iron having more weight against machinery having lighter weight.

b) Little difference has been made to its original form after its formulation: For e.g. gold which changes its shape in the form of jewelry. In this case, the Shariah holds that such a transaction should not happen in the first place or if it does, the exchange should be in equal weights in order to discourage unfair deals. Another alternative would be to sell gold against cash and the cash proceeds are used to buy the needed jewelry. The reason for the impressibility of the former scenario is the fact that it is not possible in a barter transaction, except for an expert, to visualize the fair equivalent of one commodity in terms of all other goods. Hence, the equivalent may be established only up to an approximate value thus leading to some injustice to one or the other party. The use of money could therefore help reduce the possibility of an unfair exchange.

3. Different commodities can be unequally exchanged but deferred payment is not allowed. For e.g. one kg wheat can be sold against 2 kg date or one gram of gold can be exchanged against 4 grams of silver on the condition that they are spot transactions.

The general conditions of sale, however, should be borne in mind while making a sale transaction so that the goods are specified in addition to the cash aspect of the transaction. The correct way of specifying is that gold and silver should be under the possession of the sellers or delivered at the place of contract.

This rule applies to only exchange of gold and silver however Other goods can be exchanged against each other.

For e.g. Suleman made a spot sale of one kg wheat to Farhan with 2 kg salt against future delivery after having identified their goods, this transaction is allowed in Shariah.

However, if Suleman was selling one tola gold to Farhan against 40 tola silver, then it is necessary that both take delivery of their purchased goods at the place of contract because without delivery, goods cannot be specified.

To sum up, the Hanafi jurists maintain that in case of commodities that weigh or measure, it is illegal to transact unequally or on credit if the transaction is between two similar commodities. But in case of different commodities unequal exchange is legal but credit remains illegal; the transaction in this case too should be spot.

Commercial Interest And Usury

In the 17th century, two new technical terms of interest emerged after the establishment of banking system, namely:

1. **Tijarti Sood (Commercial Interest):** Interest paid on loan taken for productive & profitable purposes.

2. **Sarfi Sood (Usury):** Interest paid on loan taken for personal need and expenses.

The Background Of Both Types

The present day banking system, which has given interest the moral and legal license, is the backbone of the prevalent capitalism.

When Muslim countries became subjugated to west in their economic field, some westernized Muslims in the 19th century, on one side, saw the increasing progress of the west in trade and industry and on the other side saw the shattering economic condition of fellow Muslims states. They also became conscious of the fact that banking is inevitable in the field of trade and industry not only on national level but also internationally. This prompted them to say that only usury is haram (illegal) but not commercial interest because rendering commercial interest haram would pose irresolvable problems to their way up to industrialization and economic progress. They only included usury in the term "Riba" as categorically prohibited in Qura'n and sunnah and freed commercial interest from it calling it totally different from the western concept of interest. Therefore, it was concluded that the prohibition of Riba was restricted to usury while commercial interest was perfectly Islamic.

There are two schools of thought on this issue. A detailed analysis of their arguments is discussed as under:

1. First School:

This school presents two arguments to support their point that only usury (not commercial interest) is prohibited in Islam:

Argument 1

"Riba as practiced during the days of the Prophet was only Usury"

Counter argument

This claim is groundless, since Islam when prohibiting something does not only prohibit one form of it that is prevalent, but prohibits all forms that might erupt in future. The changed state does not prohibit the ruling e.g. Qura'n has prohibited the following:

a) **Liquor (Khamar):** During the time of Prophet its form and the way of production was totally different from that of the present day liquor but the ruling remains unchanged even though the form has changed.

b) **Pork (Khinzeer):** Irrespective how clean the present day breeding of pigs in high class farms may be, pork will stay prohibited and cannot be

rendered halal (legal).

c) **Corruption/Immorality (Al Fahsha):** Although a lot of sophisticated ways have been developed of this evil from the time of Qura'nic revelations prohibiting it, the ruling stands forever.

The same applies to interest and gambling. By claiming that it was in a different form during Prophet's ﷺ time does not change its ruling. The ruling remains unchanged just as in case of Khamar, Khinzeer and Al Fahsha.

Argument 2

"Commercial interest did not exist in the days of Prophet ﷺ"

Counter argument

This claim is also wrong. If one glances through the Islamic and pre Islamic history of Arabia, it is evident that the type of interest at that time was not restricted to usury but loans were granted for commercial and profitable purposes. To quote some examples:

"كانت بنو عمرو بن عامر يأخذون الربا من بني المغيرة وكانت بنو المغيرة يربون لهم في الجاهلية .فجآء الاسلام ولهم عليهم مال كثير".(فتح القديرللشوكاني تحت قوله تعالي: "وذروا ما بقي من الربوٰ إن كنتم مؤمنين")

"The tribe of Umro bin Aamir used to take interest from the tribe of Mughairah. At the advent of Islam, Mughairah owed heavy interest to Umro bin Aamir." In this narration, the transaction of interest between 2 tribes of Arabia have been pointed out who actually operated as trading companies; both tribes were very wealthy. Could it be that two wealthy tribes transacted interest just for personal need and expenses? The interest was simply commercial!

a) History of the city of Ta'if tells us that it was only second to Makkah in trade (their main exports being liquor, raisins, currants, wheat, wood etc) and industry (major being leather and dyeing). The tribe of 'Saqeef'' (Jewish tribe) advanced cash on interest, not only to the natives of Ta'if, but the business community of Makkah as well eg. the tribe of Mughairah who were their permanent customer. This advancement, which was not only restricted to cash but also to commodities between wealthy tribes of Taif and Makkah who were usually traders and businessmen, was only for their commercial purposes and not for their consumption and personal needs. One of the ways of receiving interest was to double the principle amount plus interest in case of non payment of loan and this practice was applied to both cash as well as commodities. They had become accustomed to it.

At the time of signing the peace treaty with the people of Ta'if, the Prophet imposed conditions: i) Total elimination of interest based transactions. ii) Giving up of interest owed to and from them.

b) The practice of making two trade trips, one to Yemen in winters and the other to Syria in summer was started by the tribe of Quraish of Makkah. These trips proved to be very profitable especially since being custodians of Kaa'ba, Quraish were looked at with respect, granted special concessions and protected in transit which was a necessity at that time. This way business & trade became their only means of livelihood. Investment became the order of the day in which women also took part and its circulation flourished and multiplied. With this background in mind, one can easily visualize that the city of Makkah more or less became the clearing house or the banking city and accustomed to their related amenities. It was only natural that interest was one of them. Since they advanced cash for commercial purposes and charged compound interest incase of default by the traders, and this earning of interest was their trade, they argued when Qura'n rendered interest haram (illegal) that the transaction of interest based loans is a type of trade in which the return on capital can be earned as in the caseof rent received from assets. They could not differentiate between excess in shape of profit during a trade and excess in the shape of interest at the time of repayment of loan.

c) Therefore in pre Islamic days, we see that Syyidnna Abbas Ibn Abdul Muttalib رضی اللہ تعالی عنہ and Syyidnna Khalid Ibn Waleed رضی اللہ تعالی عنہ formed a company with joint capital whose prime business was cash advancement on interest. Similarly Syyidnna Usman رضی اللہ تعالی عنہ was one of the wealthy businessmen who lent money on interest.

There were many other traders dealing full time in interest extending a network of interest based transactions.

d) The way Syyidnna Zubair Ibn Awwaam رضی اللہ تعالی عنہ, who was famous for his trustworthiness, operated was quite similar to that of modern banking system. People used to deposit with him their capital as Amanah (trust or security). However, Syyidnna Zubair رضی اللہ تعالی عنہ used to make it clear to the depositors that he would accept the deposits as a 'loan' and not as 'security' (Amanah). Because he knew that he would not be fully liable according to Shariah in case these Amanaat got destroyed but in case of having them as a loan, he will be fully liable to pay them back. He was afraid that in case of losing any deposited amount, his image as the trustworthy caretaker would be damaged. He therefore used the term 'loan' for such deposits to ensure guaranteed payment so that he enjoys everyone's confidence in him. Another reason for using the word 'loan' was to legalize trading and earning profits on such deposits. Because if he got those deposits as Amanah, he could not utilize it for his business, as it is not permissible in Shariah to use Amanah. This

clearly shows that borrowing in those days was not only for consumption purposes but for commercial purposes as well. Syyidnna Zubair left a will with his son Syyidnna Abdullah Ibn Zubair before he died to sell his property to repay the loan, if required. The total amount calculated after his death for repayment by his son was 22 lacs. It is obvious that a rich Sahabi such as Syyidnna Zubair did not owe this loan of 22 lacs out of any need; rather it was an investment of securties that was circulating in trade.

Another Clear Argument

Syedna Abu Hurairah narrated that the Prophet ﷺ said,

"من لم يترك المخابرة فليأذن بحرب من اللّه ورسوله"(في صحيح بن حبان في ذكر التغليظ علي من لم يترك المخابرة)

“He who does not abandon Mokhabara, will be caught in a war against Allah & His Prophet ﷺ ”

In this narration Prophet ﷺ has rendered Mokhabara illegal just like riba and has declared a war against those who indulge in it just like riba.

What is Mokhabara?

Mokhabara is a division of crop by agreement between the landlord and cultivator in which the landlord gives his land to cultivator for cultivation purposes in order to get his pre-agreed amounts of the crop irrespective whether the production is low or high. For eg. "A" lends his land to 'B' for cultivation on the condition that he will get a predetermined portion on each crop eg. 5 mounds. Such a transaction is called Mokhabara.

Prophet Muhammad ﷺ had called Mokhabara a form of riba. Now one should think over whether he referred to usury as the form of riba or he referred to commercial interest. It is similar to commercial interest as both Mokhabara and commercial interest are used for productive businesses. Whereas in the case of usury, the borrower uses the loan for personal use and not productive purposes.

To sum up, Prophet ﷺ included Mokhabara in riba that has no similarity with usury, rather with commercial interest. The fact that during Prophet's time, the dealing in commercial interest was common is proven and also that this form is prohibited.

2. Second School:

This group presents two arguments justifying their point of view that are mentioned below:

Argument

This argument is based on the Qura'nic verse

'يَا ايُّهَا الَّذِيْنَ آمَنُوْا لاَ تَأْكُلُوْا اَمْوَالَكُمْ بَيْنَكُمْ بِالبَاطِلِ اِلاَّ أَنْ تَكُوْنَ تِجَارَةً عَنْ تَرَاضٍ مِنْكُمْ
" (سورة النساء, أية 29)

“O you who believe, do not devour each other's property by false means, unless it is trade conducted with your mutual consent. Do not kill one another. Indeed, Allah has been Very-Merciful to you.” [29]

In the above verse, Qura'n has prohibited "Wrongful devouring" which will only arise if the consent of one of the parties is absent and naturally the party who is devouring consents, the other party never consents; he only gives in since he has no other option. So we come to the conclusion that if the consent and satisfaction of both parties is present in a deal, it cannot be called "Wrongful devouring" as per this verse. According to this logic, commercial interest is permissible since the mutual consent is present of both parties.

Counter argument:

This argument is of superficial nature. Mutual consent is not the criteria to evaluate a situation in Islam. Would the act of adultery be allowed if the condition of mutual consent is fulfilled? Similarly, mutual consent is present in commercial interest and gambling too but in spite of that, it has been prohibited. Therefore no such criteria exists in the legality of any transaction that both parties approve; rather the approval should be on the transaction, which has not been prohibited by Shariah.

Therefore the transactions should not be judged through the mutual consent of the parties. The criterion should rather be the underlying nature of the transaction. Since, lending of money with the stipulation of excess amount in return is explicitly prohibited; therefore mere mutual consent of the parties will not affect the intrinsic impermissible nature.

Simple And Compound Interest

Interest can be classified into two types:

- Simple Interest (Sood-e-Mufrad)
- Compound Interest (Sood-e-Murakkab)

Definition of Simple Interest

Simple interest is interest paid on the original principal only.

E.g. For a loan of Rs 10,000, interest will only be calculated on Rs 10,000. If interest rate is 10% per anum then at the end of the year interest will be Rs 1,000 and in the next year interest will be calculated on Rs 10,000 which was the initial principal of loan.

Definition of Compound Interest

Compound interest arises when interest is added to the principal, so that,

from that moment on, the interest that has been added also earns interest. This addition of interest to the principal is called compounding

E.g. For a loan of Rs 10,000, If interest rate is 10% per anum then at the end of the year the interest will be Rs 1,000 and in the next year interest will be calculated on Rs 11,000 which is the initial principal of loan plus the interest accrued over the final principal of loan.

During the pre-Islamic era, when a borrower failed to pay back the principal and interest charged on him, then the lender used to extend the loan on the condition that the interest will also become part of the loan (essentially Compound Interest). The following verses of Quran were revealed in order to stop the people from such practices:

يَا اَيُّهَا الذِيْنَ آمَنُوْا لاَ تَأكُلُوْا الرِّبَا اَضْعَافًا مُضَاعَفَةً وَاتَّقُوْا اللّهَ لَعَلَّكُمْ تُفْلِحُوْنَ (سورة أل عمران , أية 130)

“O you believe, do not eat up the amounts acquired through Riba (interest), doubled and multiplied. Fear Allah, so that you may be successful”[130]

To eradicate this abominable practice of the period of ignorance, this verse was revealed. By mentioning the practice of taking interest in a doubled and multiplied manner, it was condemned and declared unlawful in view of its adverse impact on the community and the selfishness that it bred. It does not mean that if there is interest without it being doubled and multiplied (i.e. if there is simple interest, in today's jargon), then it is lawful. In Surah Al Baqarah (The Cow) and Surah An Nisa (The Women), the prohibition of interest in its entirety and in absolute terms is clearly mentioned, no matter interest is doubled and multiplied or not.

Since the aforementioned verse prohibits the compound interest only, some people misinterpret it even today that compound interest alone is forbidden in Islam, not the simple interest. They fail to see that there is absolute prohibition of simple interest in a number of other Quranic verses. The reason that the above verse specifically uses the words "doubled and multiplied interest " is to highlight the shameful aspect of compound interest and not to limit the scope of riba only to compound interest. This is similar to Allah's command "Do not bargain on My orders for paltry gains in this world." The reason for mentioning paltry gains is that even if all conceivable material goods and luxuries of this world are obtained in exchange for ignoring Allah's commands, even then this is a paltry gain. It does not obviously mean that it is prohibited to obtain paltry gains but permissible to obtain (by one's standard or judgment) a hefty price. Similarly, in the Ayat under consideration, the mention of doubling and redoubling is to condemn the shameful practice rather than limit its permissibility.

Revelations On Simple & Compound Interest

Verses on absolute prohibition of Simple and Compound Interest

"يَا اَيُّهَا الَّذِيْنَ اٰمَنُوا ا تَّقوْا اللّه وَذَرُوْا مَا بَقِيَ مِنَ الرِّبَا اِنْ كُنْتُمْ مُؤْمِنِيْن، فَاِنْ لَّمْ تَفْعَلُوْا فَأْذَنُوْا بِحَرْبٍ مِنَ اللّه وَرَسُوْلِهِ، وَاِنْ تُبْتُمْ فَلَكُمْ رُوؤُسُ اَمْوَالِكُمْ لاَ تَظْلِمُوْنَ وَلاَ تُظْلَمُوْن" (سورة البقرة , أية 278-279)

"O you who believe, fear Allah and give up what still remains of riba, if you are believers.[278] But if you do not (give it up), then listen to the declaration of war from Allah and His Messenger. However, if you repent, yours is your principal. Neither wrong, nor be wronged.[279]"

The above two verses demand to abandon the amount of riba and directs that only the principal amount should be paid back, nothing in excess. The second verse explains that any excess on principal, no matter how insignificant, is cruel.

The following hadith also proves that both simple and compound interest are forbidden:

"ألا ان كل ربا من رباالجاهلية موضوع . لكم روؤس اموالكم لا تظلمون ولا تظلمون وأوّل ربا موضوع ربا العباس بن عبد المطلب كله"(تفسير ابن ابي حاتم قوله تعاليٰ: فلكم رؤس أموالكم) (سورة البقرة , أية274)

"Listen! all Riba liable to you in the pre-Islamic days have been completely eliminated. You have to pay back the principal amount only. Neither hurt someone nor get hurt by someone. And the first riba to be completely eliminated is of Abbas bin Mutalib ؓ".

The above evidence proves that the claim that 'only compound interest is prohibited and any riba less than that is allowed in Islam,' is wrong. Any amount in excess of the principal fixed in the contract of a loan is called Riba An Nasiyah

Chapter 6

Islamic Contract

We will start our discussion of Islamic Contract with three terminologies of the Islamic Jurisprudence which are pertinent to be understood at the outset of this chapter. They are:

1 Unilateral Promise(Wa'da)
2 Bi Lateral Promise (Muwa'adah or Muahaidah)
3 Contract (Aqd)

1. Unilateral Promise (WA'DA)

It means a promise. It refers to a unilateral undertaking or promise extended by one person to another in which he offers to sell or buy something in future. Since it is a unilateral promise, no question of future sale arises on future sale is not allowed in Islam. Example:

A promises to sell his car to B within the next 3 months for Rs. two hundred and fifty thousand, this is a unilateral undertaking or Wa'da.

Enforceability

- Wa'da is enforceable under the present law.

- According to Imam Abu Hanifa رحمة الله عليه Wa'da is not enforceable by law (Qada'an) however there is a moral obligation (Diayanat'an) on the promisor. However, some of the Hanfi jurist, argue that some of the promises can be made enforceable under the doctrine of necessity.

- According to Imam Malik رحمة الله عليه Wa'da is enforceable by law.

- The consensus (Ijma) of present day Ulama is that Wa'da is enforceable by law until and unless the promisor is not in a position to fulfill his / her promisee. In this case, if it is not due to any of his negligence then he has to make good the loss to the promise. For example in case here A promises to sell a horse to B and the horse dies without any negligence on part of A, then no damages are due on A for B. But if it is due to his negligence then he has to make good the actual loss to the promisee. This will be the case where A promises to sell a horse to B for Rs. 10,000 within the next month and subsequently sells it to C before the month elapses. This is willful act of the promisor that leads to his inability to fulfill his promise to the promisee therefore the promisor needs to compensate the promisee.

A has promised to purchase a Horse from B for Rs 10,000. As a result of promise to purchase by A, B has purchased a horse for Rs 8,000 from the market to sell it to A for Rs 10,000. On the promised date of purchase A refused to purchase the Horse from B. As a result of breach of promise by A, the horse was sold by B in the market for Rs 7,500 at a loss of Rs 500. This loss of Rs 500, being the actual loss as a result of breach of promise by A, can be claimed by B from A.

2. Agreement (Muwa'adah or Mu'ahadah)

- It means bilateral undertaking (Mutual promise) or agreement.

- According to majority of the present day Scholars of Islamic Jurisprudence, Muwa'adah is not allowed in situations where Aqd is not allowed (e.g. forward contracts), and thus is not enforceable by law. This view is adapted by majority of Islamic Financial Institutions of present day and even by AAOIFI.

- According to some Scholars of the Sub-continent (Followers of Hanafi School), Muwa'adah is enforceable by law, however, Muwa'adah of transactions like short-selling of currencies or shares is not allowed.

3. Contract (AQD')

An Aqd' or contract is a Bilateral Agreement that is executed between two or more parties.

Example:
Contract of Sale, Contract of Marriage etc.

Types of Aqd'

1.Uqood Mu'awadah
2.UqoodGhaer Mu'awadah

Compensatory Contract (Uqood e Mu'awadah)

These are compensatory contract where one person sells something to someone else for a price or compensation for example sale of a pen by A to B for Rs. 50.

Non Compensatory Contract (Uqood e Ghaer Mu'awadah)

These are non- compensatory contracts where one person gives something to some one else without any compensation for example a contract of loan or gift.

Essentials of Aqd'

Four essential elements are required to constitute a valid Aqd.

1. contractors (Mutaa'qidain)
2. Wording of Contract (Alfaz e Aqd)
3. Subject Matter (Ma'qood Alaih)
4. Consideration (Ma'qood Bi'hi)

contractors (Mutaa'qidain)

The contractors must not be mahjoor i.e. restricted to make a contract. Islamic Shariah identifies 3 types of people as mahjoor.

- An insane person
- A child not mature enough to understand the nature of transaction
- A slave not permitted by his master to enter into a contract

Wording of Contract (Alfaz e Aqd)

Alfaz e Aqd should be absolute and immediate and non-contingent to a future event as a future contract is not allowed in Islam. Also the wordings should be unconditional. If the wordings of the contract are conditional, the condition must adhere to the following rules of Islamic jurisprudence.

There are four basic rules for judging the validity of conditions in a contract:

1) A condition which is not against the contract, is a valid condition.

2) A condition, which seems to be against the contract, but it is in the market practice, that type of condition is permissible unless its voidness is proven with the clear injunctions of the Holy Quran and Sunnah. For example, 'A' buys an air conditioner on a condition that the seller will provide him five-year guarantee and one year free service. This type of condition does not invalidate the contract.

3) A condition that is against the contract and not in the practice of market but it is in favor of one of the contractors, this type of condition is void. For example, if 'A' says he sells a car with a condition that he will use it on a fixed date every month, this contract will be void.

4) A condition, which is against the contract, not in the market practice, and not in favor of any contractor, is not a void condition.

Now a question arises what is the ruling of void condition, whether it invalidates the contract or not?

The answer lies in detail about the impacts of void condition. Sometimes a void condition invalidates the contract and sometimes it does not invalidate the contract, however, the condition itself is annulled.

To elaborate this, Islamic jurists and scholars have written that the compensatory contract (Uqood Mu'awadah) like sale, purchase, lease agreements become void by putting a void condition. However, non-compensatory (voluntary) contracts (Uqood Ghair Mu'awadah) like contract of loan (Qard-e-Hasanah), do not become void because of void condition. However, the void condition, itself becomes ineffective. For example if 'A' gives to 'B' a loan with a condition of premium at the time of repayment, this condition of interest is void. However, this condition does not invalidate the contract, therefore all transaction done by this borrowed money, will be valid. But the condition of interest itself is revoked; therefore 'B' is not liable for the payment of interest.

Subject Matter (Ma'qood Alaih)

The subject matter should exist, valuable, usable under Shariah, capable of ownership & title and delivery & possession. Also it should be specified & quantified and seller must have its title and risk at the time of the sale. For example, a certain mobile phone.

Consideration (Ma'qood Bihi)

It should be quantified and specified & ascertained at the time of executing the Contract. For example, a price of Rs. 300. It should be noted that Ma'qood Bihi (consideration) is not required for Uqood Ghair Mu'awadah.

Other Issues in Aqd

We will discuss two more issues in Aqd' here.

1. Safqatain fi Safqatin (Two contracts in one contract)
2. Tawkeel fil Aqd' (Agency contract)

Two contracts in one contract (Safqatain fi Safqatin)

It means accumulation or mixing up of two different contracts in such a manner that execution of one becomes contingent on execution of another. This is not allowed by the Holy Prophet ﷺ and it renders a contract void. This is why, Hire purchase contract in not allowed in Islam.

Agency or Wakalaah contract (Tawkeel fil Aqd')

It means the appointment of an agent (wakil) on behalf of a contractor to carry out a contract or trade on behalf of the principal. There are two types of contracts:

1. One in which all the rights and obligations are passed on the principal (Muwakkil) from the contractor for example that of Nikkah (Contract of marriage). Therefore, if a person A makes B his agent to marry him with

a lady C then B is not responsible for any rights, responsibilities and benefits, if Nikkah (Marriage) is between A and C. Hence, lady C can only claim for her dower (Mehr) and other expenses from A directly.

2. Second in which the rights and obligations remains with the agent for example if A appoints B as his agent and B buys a car from C for Rs. 500,000 on credit and does not disclose this to C that he is acting as an agent for A then C can claim his money from only B. However if B discloses this then C can claim his money from A as well.

Investment Agency: (Wakalah Isthithmar)

It means the transaction in which one party appoints other party its agent to carry out a trade transaction on behalf of the principal. The difference between the Wakalah Isthithmar Contract and Mudarbah Contract is that in Mudarbah Contract both the parties share in the profit arising out of the trade transaction whereas in Wakalah Isthithmar contract the wakeel is only given a Fee for his services by the principal and does not share in the profit.

In the classical books of fiqh it is called Ijaratul Ashkaas. The remuneration of the agent can be fixed, lump sum or on commission basis.

Chapter 7

Elements Of A Valid Sale

A valid sale has four essential elements:

Contract or transaction (Aqd)

Offer and acceptance (Ijab-o-Qobool)

The term "Offer" means that one person proposes to either sell his commodity to another person or buy from him and "Acceptance" means that the person who has been offered gives his approval of the proposal. Offer and acceptance are always done in past tense eg. "I have sold" or "I have purchased" etc. There are two ways of doing it:

Oral (Qauli)

By saying. The offer (Ijaab) and Acceptance (Qabool) should be communicated orally between the parties in such a manner that the transaction is executed spontaneously. E.g. one can say “I have sold” but one cannot say “I shall sell to you”.

Implied (Isharaa)

By indicating. E.g. Exchange of money with goods without uttering Ijab-o-Qobool for instance, procedure adopted in various supermarkets & departmental stores

Buyer & seller (Muta'aqiain)

Both must be

Sane

Should be mentally sound at the time of contract.

Mature

Should be adult, however, in case of minor, he must understand the nature of transaction.

Conditions of contract (Sharaet-e-Aqd)

Sale must be non-contingent

The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance. For example, 'A' sells his stolen car to 'B' who purchases it in the hope that he will manage to recover it. The sale is void.

(a) Unconditional contract

The sale must be unconditional for example. 'A' buys a car from 'B' with a condition that B will employ his son in his firm. The sale is conditional and hence invalid.

(b) Under reasonable conditions

The conditions which do not go against the contract for instance, 'A' tells 'B' to deliver the goods within a month, the sale is valid.

(c) Under unreasonable condition but in market practice

If a sale is under unreasonable condition but is in market practice, the sale is valid. For eg. 'A' buys a refrigerator from 'B' with a condition that 'B' undertakes its free service for 2 years. The condition being recognized as a part of the transaction, is valid and the sale is lawful in Shariah.

Sale must be immediate

The sale must be immediate and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void. If the parties wish to affect a valid sale, they will have to affect it afresh when the future date comes or the contingent event actually occurs. For example, 'A' says to 'B' on the first of January: "I sell my car to you on the first of February". The sale is void, because it is attributed to a future date." Similarly, if 'A' says to 'B': "If x party wins the elections, my car stands sold to you", the sale is void because it is contingent on a future event, which may or may not occur However, in some specific cases, promise to sell on a future date, may be allowed.

Goods for Sale or subject matter (Mabee')

The following conditions regarding subject mater must be fulfilled:

Existence

The subject matter of sale must exist at the time of sale. Thus, a thing which has not yet come into existence or which can not be delivered / possessed now cannot be sold. If a non-existent thing has been sold, even with mutual consent, the sale is void according to shari'ah. Eg. 'A' sells the unborn calf of his cow to 'B'. The sale is void. This rule does not apply in Bai Salam & Bai Istisna.

Valuable

The subject of sale must be a property of value. Thus a thing having no value according to the usage of trade such as a leaf or a stone on a roadside cannot be sold or purchased.

Usable

The subject of sale should not be a thing which is not used except for a haram purpose, like pork, wine etc.

Capable of ownership/title

The subject matter should not be anything, which is not capable of ownership/title for example, sea or sky.

Capable of delivery/possession

Sale of any thing that due to non existence is not capable of being delivered is void. For instance, a chair which is not yet prepared cannot be delivered or possessed since it does not exist.

Specific and quantified

The subject of sale must be specifically known and identified either by pointing out the asset or by detailed specification that can distinguish it from other things, which are not sold. For instance, there is a building comprising of a number of apartments built in the same pattern. 'A' - the owner of the building says to 'B', "I sell one of these apartments to you"; 'B' accepts the offer. The sale is void unless the apartment intended to be sold is specifically identified or pointed out to the buyer.

Seller must have title and risk

The subject matter of sale must be in the ownership of the seller at the time of sale. Thus what is not owned by the seller cannot be sold. If he sells something before acquiring its ownership and risk, the sale is void. Eg. 'A' sells to 'B' a car which is presently owned by 'C' but 'A' is hopeful that he will buy it from 'C' and shall deliver it to 'B' subsequently. The sale is void, because the car was not owned by 'A' at the time of sale. The speculation in shares without acquiring ownership and risk is another example.

Price (Thaman)

Specified & certain (Muta'aiyan)

For a sale to be valid, the price should be ascertained and specified such as the total amount in rupees etc. If the price is uncertain, the sale is void. For example, 'A' says to 'B': "If you pay within a month, the price is Rs.50 but if you pay after two months, the price is Rs.55" 'B' agrees. The price in this case is uncertain and therefore the sale is void unless anyone of the two alternatives is agreed upon by the parties at the time of sale.

Price (Thaman)

The subject of sale must be in the physical or constructive possession of the seller when he sells it to another person.

Physical (Haqiqi)

For example, 'A' has purchased a car from 'B'. 'B' has not yet delivered it to 'A' or to his agent. Therefore, 'A' cannot sell the car to 'C'. If "A" sells it before taking its delivery from 'B', the sale is void.

Constructive (Hukmi)

"Constructive possession" means a situation where the possessor has not taken the physical delivery of the commodity, yet the commodity has come into his ownership and all the rights and liabilities of the commodity are passed on to him, including the risk of its destruction. For example, 'A' has purchased a car from 'B', 'B' after identifying the car has placed it in a garage to which 'A' has free access and 'B' has allowed him to take the delivery from that place whenever he wishes. Thus the risk of the car has passed on to 'A'. The car is in the constructive possession of 'A'. If 'A' sells the car to 'C' without acquiring physical possession, the sale is valid.

Valid Sale
(Bai Sahih)
Contract or transaction (Aqd) 1
Offer & Acceptance (Ijab-o-Qobool) 1.1
Oral (Qauli) (in past tense) 1.1.1
Implied (Isharaa) (in past tense) 1.1.2
Credit Sale (Istijirar) (eg settlement at the end of the month) 1.1.2(a)
Cash Sale (Taati) (eg as in Super markets) 1.1.2(b)
Buyer & Seller (Muta'aquadeen) 1.2
Sane 1.2.1
Mature (If minor, must understand nature of transaction) 1.2.2
Conditions of Contract (Sharaet-e-Aqd) 1.3
Sale must be non-contingent 1.3.1
Unconditional contract 1.3.1(a)
Under reasonable conditions 1.3.1(b)
Under unreasonable condition but in market practice (eg. waranty of 1 year on sale of fridge) 1.3.1(c)
Sale must be immediate Not deferred to future (eg property must pass on sale date not on future date 1.3.2
Sold good or subject matter (Mube'e) 2
Existable 2.1
Valuable (eg not a stone or leaf) 2.2
Usable (eg not a pig or alcohol) 2.3
Capable of ownership/title (eg not sea/sky) 2.4
Capable of delivery/possession (eg unconstructed flat having no base) 2.5
Specific & quantified 2.6
Seller must have Title & Risk 2.7
Price (Thaman) 3
Quantified (Maloom) 3.1
Specific & certain (Muta'aiyan) (eg currency etc.) 3.2
Delivery or possession (Qabza) only in respect of movable goods, not immovable 4
Physical (Haqiqi) 4.1
Constructive (Hukmi) (eg possession of documents or keys of a car) 4.2

Chapter 8

Sale

Sale (Bai) is commonly defined in shari'ah as "the exchange of a thing of value by another thing of value with mutual consent". For "the sale of a commodity in exchange of cash"

1. Valid Sale (Bai Sahih)

A sale becomes valid if the following elements are present along with all other necessary conditions:

- Contract Aqd
- Subject Matter (Mabee')
- Price (Thaman)
- Possession or delivery (Qabza)

2. Void/Non Existing Sale (Bai Baatil)

Sale will be void if any one of the conditions of offer and acceptance (1.1) [Referred to elements of valid sale Chapter 8] , conditions of Buyer & Seller (1.2) and good for sale or subject matter (2.1 - 2.5) are not complied with. In a void sale, the buyer does not have title to the subject matter and seller does not have title to the price.

3. Existing sale but void due to defect (Bai Fasid)

Sale will exist but will be void due to defect if the conditions of contract (1.3), subject matter conditions (2.6 & 2.7) and conditions of price (3.1 & 3.2) are not complied with. However, if the defect is rectified the sale becomes valid. In a fasid sale, the buyer should not possess the subject matter. If possessed with the consent of the seller, title or ownership will pass to the buyer but usage of subject matter will be impermissible. He must return the goods to the seller.

4. Valid but disliked sale (Bai Makrooh)

A sale will be Makrooh when the transaction is complete and one gets possession of the goods but is disliked eg. sale after Juma Azaan, sale after hoarding or where a third party intervenes to buy something which was under negotiation of sale between other parties.

Types of Sale

Following are the common types of sale

1. **Bai Musawamah:** It refers to a normal sale in which cost price is not known to the buyer.

2. **Bai Murabaha:** It refers to a sale in which cost of the goods and profit amount is known to the buyer.

3. **Bai Muqayada:** It refers to a barter sale excluding currency sale.

4. **Bai Surf:** It refers to the sale of gold, silver and currency.

5. **Bai Salam:** It is a kind of sale in which full payment is in advance spot while the delivery of the good is deferred to a future date.

6. **Bai Istisna:** It refers to a sale in which commodity is transacted before it comes into existence. It is basically an order to manufacture.

7. **Bai Muajjal:** It refers to a sale in which delivery of goods is at spot while payment of price is deferred to a future date. Cost is unknown in Bai Muajjal.

8. **Bai Taulia:** It is the type of sale where sale price is equal to the cost of goods.

9. **Bai Waddiyah:** It is the type of sale where sale price is less than the cost of goods.

Prohibited Sale Transactions:

Some of the major types of Sale transactions that are prohibited by Shariah are as follows:

1. **Short Selling (Sale before possession)**: It is the type of Sale where the subject matter is sold by the seller without getting the possession of the Subject Matter, which is prohibited as per the following Hadiths of Prophet ﷺ:

حدثني أبو الوليد حدثنا شعبة حدثنا عبد الله بن دينار قال سمعت ابن عمر رضي الله عنهما يقول قال النبي صلى الله عليه وسلم من ابتاع طعاما فلا يبعه حتى يقبضه

"Whoever purchases food stuff, should not sell it until he takes its possession"(Bukhari)

Short selling in Currency markets, equity markets, commodity markets in the current world scenario falls under the same category.

2) **Sale of Debt (Bai al Dain):** Dain means "debt" and Bai' means sale. Bai'-al-dain, therefore, connotes the sale of debt. If a person has a debt receivable from a person and he wants to sell it at a discount, as normally happens in the bill of exchange, it is termed in Shariah as Bai'-al-dain. The traditional Muslim jurists (fuqaha') are unanimous on the point that Bai'-al-dain is not allowed in Shariah. In fact, the prohibition of Bai-al-dain is a logical consequence of the prohibition of "riba" or interest. A "debt" receivable in monetary terms corresponds

to money, and every transaction where money is exchanged from the same denomination of money, the price must be at par value.

Similarly debt cannot be traded at Face value since it includes greater degree of Gharar as the party to whom the debt is sold is not certain about the delivery of currency since the original debtor may default. Therefore debt can not be sold, however it can only be assigned at Face value and with recourse i.e assigner of debt will be liable to fulfill its obligations even if the original debtor defaults in paying its obligations.

3) **Bai al Innah (Buy Back):** A contract of sale, where a person sells an asset on credit and then buys back at a less price for cash. This transaction is prohibited since it creates a back-door for earning profit over a loan transaction. Example: A asks a loan of $10 from B. B, instead of asking for interest on this loan applies a contrivance. He sells an article to A for $12 on credit and then buys back from him the same article for cash at $10.

Chapter 9

Five Khiyars

The term khiyar refers to an option or right of the buyer & seller to rescind a contract of sale.

There are five khiyars in a sale contract which are as follows:

a. Khiyar-e-Shart (Optional condition)

At the time of sale Buyer or Seller can put a condition that either party has an option to rescind the sale within the specific number of days (such as 4 days). This option is called Khiyar-e-Shart.

Specification of the days is necessary for this Khiyar. Within this period, either party has the right to rescind/terminate the sale without any reason. If the buyer puts the condition, it is called Khiyar-e-Mushtari (option of buyer) and when put by the seller, it is called Khiyar-e-Bai (option of seller). This Khiyar is non transferable to the heirs.

b. Khiyar-e-Roiyyat (Option of inspecting goods)

Here the goods can be returned after inspection, if they are not up to the specifications. This applies automatically to all contracts. for example, 'A' buys machinery from 'B' without seeing. However, 'A' has the option to return the machinery after inspection.

c. Khiyar-e-Aib (Option of defect)

Where the goods can be returned if found defective. It is the responsibility of the seller to supply the goods free of defect or point out the defect to the buyer. The seller is not allowed to hide the defect of the goods because it constitutes as fraud. In one of the hadiths, Prophet has stated "He is not amongst us who indulges in fraud." Therefore the buyer has the right to return the good in case where presence of a deficiency is considered a defect in the market practice and which depreciates the value of the goods. For example, 'A' buys batteries from 'B'. However, 'A' has the option to return them to 'B' if the batteries are found to be defective or not in working condition.

d. Khiyar-e-Wasf (Option of quality)

This option is available where the seller sells the goods by specifying a certain quality which is absent in the goods. For example 'A' buys a car from 'B' who has specified automatic transmission in the car. However when 'A'

uses the car, finds the transmission to be manual. Therefore he has the right to return the car to 'B' in the absence of a specific quality.

e. Khiyar-e-Ghaban (Option of price)

Where the seller sells the goods at a price which is far expensive than the market price and the market price is not known to the buyer, the Buyer has the right to return it to the seller. For example, a Parker pen is sold to 'A' by 'B' at a price of Rs.500/-. However after the sale, 'A' discovers its market price to be Rs.250/-, In this case "A" has the option to return the pen to 'B'.

Iqala (Recession of Contract): Where the parties freely consent to rescind the contract i.e. each party will give back the consideration received by it at the time of execution of contract.

Neither the buyer nor the seller has the sole right to rescind the contract after execution of a contract. Often the buyer wants to rescind the contract after buying goods. In this case, it is necessary that he gets the consent of the seller. Therefore this mutual agreement between buyer and seller to rescind the contract is called Iqala.

In one of the narrations, Prophet ﷺ has stated

"He who does the Iqala (rescinding of the contract) with a Muslim who is not happy with his transaction, Allah will forgive his sins on the Day of Judgment."

However, it may be noted that the price of the goods being returned under Iqala will remain unchanged.

Chapter 10

Musharakah

Hadiths-e-Qudsi

"عن ابي هريرة رضي الله تعالي عنه قال : قال رسول الله صلي الله عليه وسلم:يقول الله تعالي:أنا ثالث الشريكين ما لم يخن احدهما فَإِذَا خَانَهُ خَرَجْتُ مِنْ بَيْنِهِمَا".(سنن أبي داود)

Allah Subhan-o-Tallah has declared that He will become a partner in a business between two Mushariks until they indulge in cheating or breach of trust (Khayanah).

In another Hadiths-e-Qudsi it is stated:

عن أبي حيان التيمي عن أبيه قال قال رسول الله صلى الله عليه و سلم : يد الله على الشريكين ما لم يخن أحدهما صاحبه فإذا خان أحدهما صاحبه رفعها عنهما (سنن الدار قطني, كتاب البيوع)

Allah's hand is with both the partners unless any one of them indulge in cheating and when any one of them indulges in cheating than Allah takes back his hand from both the partners.

Definition and classification of Musharakah

The literal meaning of Musharakah is "sharing". The root of the term "Musharakah" in Arabic is from the word Shirkah, which means 'being a partner'. It is used in the same context as the term "shirk" meaning" partner to Allah". Under Islamic jurisprudence, Musharakah means "a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution". It is an ideal alternative for the interest based financing with far reaching effects on both the production and distribution of wealth in the economy. The connotation of this term is limited than the term "Shirkah", more commonly used in the Islamic jurisprudence. For the purpose of clarity in the basic concepts, it will be pertinent at the outset to explain the meaning of each term, as distinguished from the other. "Shirkah" means "Sharing" and in the terminology of Islamic Fiqh, it has been divided into two kinds:

(1) **Shirkat-ul-Milk (Partnership by joint ownership):** It means joint ownership of two or more persons in a particular property. This kind of "Shirkah" may come into existence in two different ways:

   a) **Optional (Ikhtiari):** At the option of the parties. For example, if two or more persons purchase equipment, it will be owned jointly

by both of them and the relationship between them with regard to that property is called "Shirkat-ul-Milk Ikhtiari" Here this relationship has come into existence at their own option, as they them selves opted to purchase the equipment jointly.

b) **Compulsory (Ghair Ikhtiari):** This comes into existence automatically without any effort/action taken by the parties. For example, after the death of a person, all his heirs inherit his property, which comes into their joint ownership as a natural consequence of the death of that person.

There are two more types of Joint ownerships (Shirkat-ul-Milk):

- Shirkat-ul-Ain
- Shirkat-ul-Dain

A property in shirkat-ul-milk is jointly owned but not divided , is called Musha. Undivided asset can be utilized in the following manner:

a) **Mushtarik Intifa'(Mutual Utilization):** Mutually or jointly using an asset alternatively under circumstances where the partners or joint owners are on good terms.

b) **Muhaya(Alternate Utilization):** Under this arrangement the owners will fix number of days within a specific time interval for each partner to get usufruct of the asset. For example one may use the product for 15 days and then the other may use it for the rest of the month.

c) **Taqseem (Division):** This refers to division of the jointly owned asset. This may be applied in cases where the asset that is owned can be divided permanently. For example, jointly taking a 1,000 sq. yards plot and making a house on 500 yards by each of the two owners.

d) Under a situation where the partners are not satisfied with Alternate utilization arrangement, the property or asset jointly held can be sold off and proceeds be distributed between the partners.

(2) **Shirkat-ul-Aqd (Partnership by contract):** This is the second type of Shirkah, which means, "a partnership effected by a mutual contract". For the purpose of brevity it may also be translated as "joint commercial enterprise." Shirkat-ul-Aqd can further be classified into three kinds:

(i) **Shirkat-ul-Amwal (Partnership in capital):** where all the partners invest some capital into a commercial enterprise.

(ii) **Shirkat-ul-Aamal (Partnership in services):** where all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them according to an agreed ratio. For example, if two people

agree to undertake tailoring services for their customers on the condition that the wages so earned will go into a joint pool which shall be distributed between them irrespective of the size of work each partner has actually done, this partnership will be a shirkat-ul-aamal which is also called Shirkat-ut-taqabbul or Shirkat-us-sanai or Shirkat-ul-abdan.

(iii) **Shirkat-ul-wujooh (Partnership in goodwill):** The word has its root in the Arabic word Wajahat meaning goodwill. Here the partners have no investment at all. They purchase commodities on deferred price, by getting favorable credit terms because of their goodwill and sell goods at spot. The profit so earned is distributed between them at an agreed ratio.

Each of the above three types of Shirkat-ul-Aqd are further divided into two types:

a) **Shirkat-Al-Mufawada (Capital, labor & Profit at par):** All partners share capital, management, profit, risk & reward in absolute equality. It is a necessary condition for all four categories to be shared amongst the partners; if any one category is not shared in absolute equality, then the partnership becomes Shirkat-ul-'Inan. Every partner who shares equally is a Trustee, Guarantor and Agent on behalf of the other partners.

b) **Shirkat-ul-Ainan:** A more common type of Shirkat-ul-Aqd where capital, management or profit ratio is not equal in all respect.

All these modes of "Sharing" or partnership are termed as "Shirkah" in the terminology of Islamic Fiqh, while the term "Musharakah" is not found in the books of Fiqh. This term (i.e. Musharakah) has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of "Shirkah", that is, the Shirkat-ul-Amwal, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes Shirkat-ul-Aamal also where partnership takes place in the business of services.

It is evident from this discussion that the term "Shirkah" has a much wider sense than the term "Musharakah" as is being used today. The latter is limited to "Shirkat-ul-Amwal" only i.e. all the partners invest some capital into a commercial enterprise, while the former includes all types of joint ownership and those of partnership.

Rules & Conditions of Shirkat-ul-Aqd

Common conditions are three which are as follows:

a) **The existence of Muta'aqidain (Partners)**

b) **Capability of Partners:** The partners must be sane & mature and capable of entering into a contract. The contract must take place with free consent of the parties without any fraud or misrepresentation.

c) **The presence of the commodity:** This means the price and commodity itself.

Special conditions are also three which are as follows:

a) **The commodity should be capable of an Agency:** As each partner is responsible for managing the project, therefore he will directly influence the overall profitability of the business. As a result, each member in Shirkat-ul-Aqd should duly qualify as legally being eligible of becoming an agent and of carrying on business e.g. 'A' has written a book and owns it, 'B' cannot sell it unless 'A' appoints 'B' as his agent.

b) **The rate of profit sharing should be determined:** The share of each partner in the profit earned should be identified at the time of the contract. If however, the ratio is not determined before hand the contract becomes void (Fasid). Therefore, identifying the profit share is necessary.

c) **Profit & Loss Sharing:** All partners will share in the profit as well as the loss. By placing the burden of loss solely on one or a few partners makes the partnership invalid. A condition for Shirkat-ul-Aqd is that the partners will jointly share the profit. However, defining an absolute value of profit is not permissible, therefore only a percentage of the total return is allowed.

The Basic rules of Musharakah

Musharakah or Shirkat-ul-amwal is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary ingredients of a valid contract must be present here also. For example, the parties should be capable of entering into a contract; the contract must take place with free consent of the parties without any duress, fraud or misrepresentation, etc.

But there are certain elements, which are peculiar to the contract of "Musharakah". They are summarized here:

Basic rules of Capital

The capital in a Musharakah agreement should be:

a) **Quantified (Ma'loom):**
Meaning how much money is invested.

b) Specified (Muta'aiyan):
Meaning specified in terms of currency.

c) Not necessarily be merged:
The mixing of capital is not required.

d) Not necessarily be in liquid form:
Capital share may be contributed either in cash/liquid or in the form of commodities. In case of a commodity, the market value of the commodity shall determine the share of the partner in the capital.

Management of Musharakah

The normal principle of Musharakah is that every partner has a right to take part in its management and to work for it. However, the partners may agree upon a condition that the management shall be carried out by one of them, and no other partner shall work for the Musharakah. But in this case the sleeping partner shall be entitled to the profit only to the extent of his investment, and the ratio of profit allocated to him should not exceed the ratio of his investment, as discussed earlier.

However, if all the partners agree to work for the joint venture, each one of them shall be treated as an agent of the other in all matters of business. Any work done by one of them in the normal course of business shall be deemed as authorized by all the partners.

Basic rules of distribution of Profit

1. The ratio of profit for each partner must be determined in respect of the actual profit earned by the business and not in proportion to the capital invested by him. For example, if it is agreed between them that 'A' will get 1% of his investment, the contract is not valid.

2. It is not allowed to fix a lump sum amount for anyone of the partners or any rate of profit tied up with his investment. Therefore if 'A' & 'B' enter into a partnership and it is agreed between them that 'A' shall be given Rs.10,000/- per month as his share in the profit and the rest will go to 'B', the partnership is invalid.

3. If both partners agree that each one will get percentage of profit based on his capital proportion, whether both take part in the management of the business or not, it is allowed.

4. It is also allowed that if an investor is working, his profit share (%) could be more than his capital share (%) irrespective whether the other partner is working or not. For example if 'A' & 'B' have invested Rs.1000/- each in a business and it is agreed that only 'A' will work and will get 2/3rd of the profit while 'B' will get 1/3rd. Similarly if the condition of work is also imposed on 'B' in the agreement, then the proportion of profit for 'A' can be more than his investment.

5. If a partner has put an express condition in the agreement that he will not work for the Musharakah and will remain a sleeping partner throughout the term of Musharakah, then his share of profit cannot be more than the ratio of his investment. However, Hanbali school of thought considers fixing the sleeping partners profit share more than his investment share to be permissible.

6. It is allowed that if a partner is not working, his profit share can be established as less than his capital share.

7. If both are working partners, the share of profit can differ from the ratio of investment. For example, Zaid & Bakar both have invested Rs.1000/- each. However Zaid gets 1/3rd of the total profit and Bakar gets 2/3rd, this is allowed. This opinion of Imam Abu Hanifa رحمة الله عليه is based on the fact that capital is not the only factor for profit distribution but also labor and work. Although the investment of two partners is the same but in some cases quantity and quality of work might differ.

Basic rules of distribution of Loss

All scholars are unanimous on the principle of loss sharing in Shariah, based on the saying of Syyednna Ali Ibn Talib رضی اللہ تعالیٰ عنہ that is as follows:

"الوضيعة علي المال والربح علي ما اصطلحوا عليه" (كنز العمال, كتاب القراض و المضاربة من قسم الأفعال)

"Loss is distributed exactly according to the ratio of investment and the profit is distributed according to the agreement of the partners."

Therefore the loss is always subject to the ratio of investment For example, if 'A' has invested 40% of the capital and 'B' has invested 60%, they must suffer the loss in the same ratio as of their investment proportion, not more, not less. Any condition contrary to this principle shall render the contract invalid.

Powers & Rights of Partners in Musharakah

After entering into a Musharakah contract, partners have the following rights:

a) The right to sell the mutually owned property since all partners are representing each other in Shirkah and all have the right to buy & sell for business purposes.

b) The right to buy raw material or other stocks on cash or credit, using funds belonging to Shirkah, to put into the business.

c) The right to hire people to carry out business, if needed.

d) The right to deposit money & goods of the business belonging to Shirkah as depositor trust where and when necessary.

e) The right to use Shirkah's fund or goods in Mudarabah.

f) The right of giving Shirkah's funds as hiba (gift) or loan. If one partner for purpose of investing in the business has taken a Qard-e-Hasana, then paying it becomes liable on both.

Termination of Musharakah

Musharakah will stand terminated in the following cases:

1. If the purpose of forming the Shirkah has been achieved. For example, if two partners form a Shirkah for a certain project such as buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment, the rules are simple and clear in this case. The distribution of profit will be as per the agreed rate, whereas in case of loss each partner will bear the loss according to his ratio of investment.

2. Every partner has the right to terminate the Musharakah at any time after giving his partner a notice that will cause the Musharakah to end. For dissolving this partnership, if the assets are liquidated, they will be distributed between the partners on the following basis.

   a) If there is no profit and no loss to the assets, they will be distributed on pro rata basis.

   b) In case of loss, all assets are distributed on pro rata basis.

3. In case of a death of any one of the partners or any partner becoming insane or incapable of effecting commercial transaction, the Musharakah stands terminated.

4. In case of damage to the share capital of one partner before mixing the same in the total investment and before affecting the purchase, the partnership will stand terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then the loss will be shared by all and the partnership will not be terminated.

Termination of Musharakah without closing the business

If one of the partners wants termination of the Musharakah, while the other partner or partners like to continue with the business, this purpose can be achieved by mutual agreement. The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of Musharakah with one partner does not imply its termination between the other partners.

However, in this case, the price of the share of the leaving partner must be determined by mutual consent. If there is a dispute about the valuation of the share and the partners do not arrive at an agreed price, the leaving partner may compel other partners on the liquidation or on the distribution of the assets themselves.

The question arises whether the partners can agree, while entering into the contract of the Musharakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners or the majority of them wants to do so. And that a single partner who wants to come out of the partnership shall have to sell his share to the other partners and shall not force them on liquidation or separation.

This condition may be justified, especially in the modern situations, on the ground that the nature of business, in most cases today, requires continuity for its success. The liquidation or separation at the instance of a single partner only may cause irreparable damage to the other partners.

If a particular business has been started with huge amounts of money which has been invested in a long-term project, and one of the partners seeks liquidation in the infancy of the project, it may be fatal to the interests of the partners, as well as to the economic growth of the society, to give him such an arbitrary power of liquidation or separation. Therefore, such a condition seems to be justified, and it can be supported by the general principle laid down by the Holy Prophet ﷺ in his famous hadith:

"المسلمون علي شروطهم الا شرطا حرّم حلالا أو احلّ حرامًا الخ " (كنز العمال, الفصل الأول في الأمان و المعاهدة و الصلح)

"All conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful".

Dispute Resolution

There shall be a provision for adjudication by a Review Committee to resolve any difference that may arise between the bank and its clients (partners) with respect to any of the provisions contained in the Musharakah Agreement.

Security in Musharakah

In case of Musharakah agreement between the Bank and the client, the bank shall in its own right and discretion, obtain adequate security from the party to ensure safety of the capital invested/ financed as also for the profit that may be earned as per profit projection given by the party. The securities obtained by the bank shall, also as usual, be kept fully insured at the party's cost and expenses with Takaful. The purpose of this security is to utilize this only in case of damage or loss of the principal amount or earned profit due to the negligence of the client.

The difference between interest based financing and Musharakah:

Interest Based Financing	Musharakah
A fixed rate of return on a loan advanced by the financier is predetermined irrespective of the profit earned or loss suffered by the debtor.	Musharakah does not envisage a fixed rate of return. The return is based on the actual profit earned by the joint venture.
The financier cannot suffer loss.	The financier can suffer loss, if the joint venture fails to produce fruits.

Issues Relating To Musharakah

Musharakah is a mode of financing in Islam. Following are some issues relating to the tenure of Musharakah, redemption in Musharakah and the mixing of capital in conducting Musharakah.

Liquidity Of Capital

A question commonly asked in the operation of Musharakah is whether the capital invested needs to be in liquid form or not. The answer as to whether the contract in Musharakah can be based on commodities only or on money, varies among the different schools of thought in Islam. For example if Zaid and Bakar agree to invest Rs.1,000 each in a garment business and both keep their investments with themselves. Then if Zaid buys cloth with his investment, will it be considered belonging to both Zaid and Bakar or only to Zaid? Furthermore if the cloth is sold, can Zaid alone claim the profit or loss on the sale? In order to answer this question the prime consideration should be whether the partnership becomes effective without mixing the two investments profit or loss. This issue can be resolved in the light of the following schools of thought of different fiqhs:

Imam Malik رحمة الله عليه is of the view that liquidity is not a condition for the validity of Musharakah. Therefore even if a partner contributes in kind to the partnership his share can be determined on the basis of the evaluation according to the prevalent market price at the date of the contract.

However Imam Abu Hanifa and Imam Ahmad do not allow capital of investment to be in kind. The reason for this restriction is as follows:

- Commodities contributed by one partner will always be distinguishable from the commodities given by the other partners therefore they cannot be treated as homogenous capital.

- If in case of redistribution of share capital to the partners tracing back each partner's share becomes difficult. If the share capital was in the form of commodities then redistribution cannot take place because they may have been sold by that time.

Imam Shafi رحمة الله عليه has an opinion dividing commodities into two:

- **Dhawat-ul-Amthal (Homogenous Commodities):** Commodities which if destroyed can be compensated by similar commodities in quality and quantity. Exampl e rice, wheat etc.

- **Dhawat-ul-Qeemah (Heterogeneous Commodities):** Commodities that cannot be compensated by similar commodities, like animals.

Imam Shafi is of the view that commodities of the first kind may be contributed to Musharakah in the capital while the second type of commodities cannot be a part of the capital. In case of Dhawat-ul-Amthal, redistribution of capital may take place by giving each partner the similar commodities he had invested earlier, the commodities need to be mixed so well together that the commodity of one partner cannot be distinguished from commodities contributed by the other.

The illiquid goods can be made capital of investment and the market value of the commodities shall determine the share of the partner in the capital.

It seems that the view of Imam Malik رحمة الله عليه is more simple and reasonable and meets the need of the modern business therefore this view can be acted upon.

We may therefore conclude from the above discussion that the share capital in a Musharakah can be contributed either in cash or in the form of commodities. In the latter case, the market value of the commodities shall determine the share of partner in the capital.

Mixing Of The Capital

According to Imam Shafi رحمة الله عليه the capital of partners should be mixed so well that it cannot be discriminated and this mixing should be done before any business is conducted. Therefore, partnership will not be completely enforceable if any kind of discrimination is present in the partners' capital. His argument is based on the reasoning that unless both investments will be mixed, the investment will remain under the ownership of the original investor and any profit or loss on trade of that investment will be entitled to the original investor only. Hence such a partnership is not possible where the investment is not mixed.

According to Imam Abu Hanifa رحمة الله عليه Imam Malik رحمة الله عليه and Imam Ahmed bin Hunbul رحمة الله عليه the partnership is complete only with an agreement and the mixing of capital is not important. They are of the opinion that when two partners agree to form a partnership without mixing their capital of investment, then if one partner bought some goods for the partnership with his share of investment of Rs.100,000, these goods will be accepted as being owned by both partners and hence any profit or loss on sale of these goods should be shared according to the partnership agreement.

However, if the share of investment of one person is lost before mixing the capital or buying anything for the partnership business, then the loss will be borne solely by the person who is the owner of the capital and will not be shared by other partners. However, if the capital of both had been mixed and then a part of whole had been lost or stolen the loss would have been borne by both.

Since in Hanafi, Maliki and Hanbali schools of thought mixing of the capital is not important therefore a very important present day issue is addressed with reference to this principle. If some companies or trading houses enter into partnership for setting up an industry to conduct business they need to open LC for importing the machinery. This LC reaches the importer through his bank. Now when the machinery reaches the port and the importing companies need to pay for taking possession, the latter need to show those receipts in order to take possession of the goods.

Under Shafi school of thought, the imported goods cannot become the capital of investment but will remain in the ownership of the person opening the LC because at the time of opening the LC the capital has not been mixed and without mixing the capital Musharakah cannot come into existence. Under this situation if the goods are lost during shipment the burden of loss will fall upon the opener of the LC, even though the goods were being imported for the entire industry. This is because even though a group of companies had asked for the machinery or imported goods the importers had not mixed their capital at the time of investment.

Contrary to this since the other three schools of thought believe that partnership comes into existence at the time of agreement rather than after the capital has been mixed therefore the burden of loss will be borne by all. This has two advantages:

a) In case of loss, the burden of loss will not fall upon one rather will be shared by all firms of the partner.

b) If the capital is provided at the time of the agreement it stays blocked for the period during which the machinery is being imported. While if the capital was not kept idle, till the actual operation could be conducted with the machinery the same capital could have been used for something else as well.

This shows that the decision of the three combined schools of thought is better equipped to handle the current import export situation.

Tenure Of Musharakah

For conducting a Musharakah agreement, questions arise pertaining to fixing the period of the agreement. For fixing the tenure of the Musharakah following conditions should be remembered:

a) The partnership is fixed for such a long time that at the end of the tenure no other business can be conducted.

b) Can be for a very short time period during which partnership is necessary and neither partner can dissolve the partnership.

Under the Hanafi school of thought, a person can fix the tenure of the partnership because it is an agreement and an agreement may have a fixed period of time.

In the Hanbali school of thought, the tenure can be fixed for the partnership as it is an agency agreement and an agency agreement in this school can be fixed. The Maliki school however says that Shirkah cannot be subjected to a fixed tenure. Shafi school like the Maliki consider fixing the tenure to be impermissible. Their argument is that fixing the period will prohibit conducting the business at the end of that period which in turn means that the fixing will prevent them from conducting the business.

Uses Of Musharakah / Mudarabah

These modes can be used in the following areas (or can replace them according to Shariah rules).

Asset Side Financing

- Short/medium/long - term financing
- Project financing
- Small & medium enterprises setup financing
- Large enterprise financing
- Import financing
- Import bills drawn under import letters of credit
- Inland bills drawn under inland letters of credit
- Bridge financing
- LC with margin (for Musharakah)
- Export financing (Pre-shipment financing)
- Working capital Financing
- Running accounts financing / short term advances

Liability Side Financing

- For current/ saving/mahana amdani/ investment accounts (Deposit giving Profit based on Musharkah/Mudarbah - with predetermined ratio)
- Inter- Bank lending / borrowing
- Term Finance Certificates & Certificate of Investment
- T-Bill and Federal Investment Bonds / Debenture.
- Securitization for large projects (based on Musharkah)
- Certificate of Investment based on Murabahah (e.g: Meezan Riba Free)
- Islamic Bank Musharakah bonds (based on projects requiring large amounts - profit based on the return from the project).

Risks in Musharkah Financing:

Some of the measure risks and problems that are being faced by Islamic

Banks in extending Musharkah or Mudarbah based financing are as follows:

1) **Business Risk:** In Musharakah Financing the bank is sharing the business risk with the customer since the return in Musharkah financing is dependant on the actual performance of the business. The bank should make a feasibility study of the business of the customer and should prudently evaluate the SWOTS of any business before making Musharakah financing decisions, since exposure of bank is on the business performance and not on the customer, unless and until fraud or negligence is established on part of the customer.

2) **Risk of Proper Book Keeping:** Another problem in Musharkah transaction is lack of transparent book keeping practices adopted by various companies due to taxation and other reasons. Due to this lack of transparency it is difficult to evaluate the actual performance of any business since it is not completely portrayed in the disclosed accounts of the company and in the absence of such information it is difficult to enter into a Musharkah arrangement with the customer.

3) **Customer Mindset:** In Musharkah financing the actual profits and loss of the business ate shared between the partners therefore if the business performs higher then the expectation then it will generate higher profits. If high profits are generated by the business then Bank will also be getting high profits as per the profit sharing arrangement but many customers are hesitant in providing profit that is more than the average market benchmark rate of financing.

4) **Dishonesty:** Another apprehension against musharakah financing is that the dishonest clients may exploit the instrument of musharakah by not paying any return to the financiers. They can always show that the business did not earn any profit by manipulating the records of the company. Indeed, they can claim that it has suffered a loss in which case not only the profit, but also the principal amount will be jeopardized.

5) **Operational Risk:** Success of Musharakah depends upon better management of the factors of operational risks, which include:

a) Control over management
b) Transparency in income
c) Commitment by management

Islamic Banks can take following steps for proper management of Operational risks in Musharakah.

a) By appointing bank's representatives in:

- Company's BOD
- Finance &
- Internal audit

These representative should be given proper authority & will be directly reporting to Bank's management

6) Credit Risk: In Musharakah the Musharik bank is exposed to similar credit risks as other banks, which include: Risk of default and Party risk.

Credit risk can be mitigated by:

- Proper evaluation of the customers financial position
- Any Shariah Compliant security can be taken to secure the bank against any dishonesty or act of negligence by the customer.
- Evaluation of customers credit history
- Past relationship with bank

Chapter 11

Mudarabah

Glossary

Mudarib : Working Partner (brings effort)
Ras-ul-Maal : Investment
Rab-ul-Maal : Investor (brings capital)
Wakeel : Agent
Ameen : Trustee
Kafeel : Guarantor

Definition

This is a kind of partnership where one partner gives money to another for investing in a commercial enterprise. The investment comes from the first partner who is called "Rab-ul-Maal" while the management and work is an exclusive responsibility of the other, who is called "Mudarib" and the profits generated are shared in a predetermined ratio.

Types of Mudarabah

There are 2 types of Mudarabah namely:

1. **Al Mudarabah Al Muqayyadah:** Rab-ul-Maal may specify a particular business or a particular place for the mudarib to carryout the business, in which case he shall invest the money in that particular business or place. This is called Al Mudarabah Al Muqayyadah (restricted Mudarabah).

2. **Al Mudarabah Al Mutlaqah:** However, if Rab-ul-maal gives full free dom to Mudarib to undertake whatever business he deems fit, this is called Al Mudarabah Al Mutlaqah (unrestricted Mudarabah). However Mudarib cannot, without the consent of Rab-ul-Maal, lend money to anyone. Mudarib is authorized to do anything, which is normally done in the course of business. However if Mudarib wants to have an extraordinary work, which is beyond the normal routine of the traders, he cannot do so without express permission of Rab-ul-Maal. He is also not authorized to:

   a) keep another Mudarib or a partner
   b) mix his own investment in that particular Mudarabah without the consent of Rab-ul Maal.

All conditions of Offer & Acceptance are applicable to both the parties. A Rab-ul-Maal can execute a contract of Mudarabah with more than one person through a single transaction. It means that Rab -ul- Maal can offer his money to 'A' and 'B' both so that each one of them can act for him as

Mudarib and the capital of the Mudarabah shall be utilized by both of them jointly

Difference between Musharakah and Mudarabah

	Musharakah	Mudarbah
1.	All partners invest in the business.	Only Rab-ul-Maal invests in the business,
2	All partners have the right to participate in the management of the business and work for it.	Rab-ul-maal has no right to participate in the management which is carried out by the Mudarib only.
3	All partners share the loss proportionately, to the extent of the ratio of their investment.	Only Rab-ul-maal bears the loss because the Mudarib does not invest anything. However, this is subject to a condition that the Mudarib has worked with due diligence.
4	As soon as the partners mix up their capital in a joint pool, all the assets become jointly owned by all of them according to the proportion of their respective investment. All partners benefit from the appreciation in the value of the assets even if profit has not accrued through sales.	The goods purchased by the Mudarib are solely owned by Rab-ul-maal and the Mudarib can earn his share in the profit only if he sells the goods in a profitable manner.

Investment

In Mudarabah, Rab-ul-maal provides the capital investment and Mudarib looks after the management. Therefore, the Rab-ul-maal should hand over the agreed investment to Mudarib and leaves everything to Mudarib with no interference from his side but he may:

a) oversee the Mudarib's activities and
b) work with Mudarib if the Mudarib consents.

In what form should the capital be? Can non-liquid assets like equipment, land etc. form capital investments?

The basic principle is that the capital in Mudarabah is valid just the way it is in Shirkah which according to Hanafi fiqh should be in liquid form. But, according to other scholars equipment, land etc can also be included as capital Investment. However all agree on the following:

Assets other than cash can be used as an intermediate step. However, this is subject to the determination of exact value of the assets before it is used for Mudarabah. If the assets are not correctly evaluated, the Mudarabah is not valid.

Mudarabah Expenses

The Mudarib shares profit of the Mudarabah as per agreed rate with the investor but his expenses like meals, clothing, conveyance and medical are not borne by Mudarabah. However, if he is traveling on a business trip and is overstaying the night, then the above expenses shall be covered from the capital of Mudarabah. If Mudarib goes for a journey which constitutes Safar-e-Sharai (more than 48 miles) but does not overstay the night, his expenses will not be borne by Mudarabah.

All expenses which are incidental to the Mudarabah's function like wages of employees/workers or Commission in buying/selling or stitching, dyeing expenses etc have to be paid by the Mudarabah. However all expenses can be included in the cost of commodities which Mudarib sells in the market. For example, if Mudarib is selling ready made garments then the stitching, dyeing, washing expenses etc. can be included by the Mudarib in the total cost of the garments.

If the Mudarib manages the Mudarabah within his city, he will not be allowed any expenses, but only his due profit share. Similarly, if he keeps an employee, this employee will not be allowed any expenses, but his salary.

If the Mudarabah agreement becomes Fasid due to any reason, the Mudarib's status will be that of an employee, meaning:

a) whether he is traveling or doing business in his city, he will not be entitled to any expense such as meal, conveyance, clothing, medicine etc.

b) he will not be sharing any profit and will just get Ujrat-e-Misl (prevalent remuneration) for his job.

Distribution of Profit & Loss

It is necessary for the validity of Mudarabah that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. The Shariah has prescribed no particular proportion; rather it has been left to the partners' mutual consent. They can share the profit in equal proportions and they can also allocate different proportions for Rab-ul-Maal and Mudarib. However in such cases where the parties have not predetermined the ratio of profit, the profit will be calculated at the ratio of 50:50.

The Mudarib & Rab-ul-Maal cannot allocate a lump sum amount of profit for any party nor can they determine the share of any party at a specific rate tied up with the capital. For example, if the capital is Rs.100,000/-, they cannot agree on a condition that Rs.10,000 out of the profit shall be the share of the Mudarib nor can they say that 20% of the capital shall be given to Rab-ul-Maal. However they can agree that 40% of the actual profit shall go to the Mudarib and 60% to the Rab-ul-Maal or vice versa.

It is also allowed that different proportions are agreed in different situations. For example, the Rab-ul-Maal can say to Mudarib "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit". Similarly, he can say "If you do the business in your town, you will be entitled to 30% of the profit and if you do it in another town, your share will be 50% of the profit".

Apart from the agreed proportion of the profit, as determined in the above manner, the Mudarib cannot claim any periodical salary or a fee or remuneration for the work done by him for the Mudarabah.

All schools of Islamic Fiqh are unanimous on this point. However, Imam Ahmad has allowed for the Mudarib to draw his daily expenses of food only from the Mudarabah Account. The Hanafi jurists restrict this right of the Mudarib only to a situation where Mudarib is on a business trip outside his own city. In this case he can claim his personal expenses, accommodation, food, etc. but he is not entitled to get anything as daily allowances when he is in his own city.

If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, then the remainder (if any) shall be distributed between the parties according to the agreed ratio.

The Mudarabah becomes void (Fasid) if the profit is fixed in any way. In this case, the entire amount (Profit + Capital) will be the Rab-ul-Maal's. The Mudarib will just be an employee earning Ujrat-e-Misl. The remaining amount will be called (Profit).This profit will be shared in the agreed ratio.

Roles of the Mudarib

Ameen (Trustee): To look after the investment responsibly, except in case of natural calamities.

Wakeel (Agent): To make purchases from the funds provided by Rab-ul-Maal

Shareek (Partner): Sharing in any profit of the business.

Dhamin (Liable): To provide for the loss suffered by the Mudarabah due to any act of negligence on his part.

Ajeer (Employee): When the Mudarabah gets Fasid due to any reason, the Mudarib is entitled to only the salary, Ujrat-e-Misl.

Termination of Mudarabah

The Mudarabah will stand terminated when the period specified in the contract expires. It can also be terminated any time by either of the two parties by giving notice. In case Rab-ul-Maal has terminated services of Mudarib, he will continue to act as Mudarib until he is informed of the same and all his acts will form part of Mudarabah.

If all assets of the Mudarabah are in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of Mudarabah are not in cash form, it will be sold and liquidated so that the actual profit may be determined. All loans and payables of Mudarabah will be recovered. Before termination the provisional profit earned by Mudarib and Rab-ul-Maal will also be taken into account and when total capital is drawn, the principal amount invested by Rab-ul-Maal will be given to him, balance will be called profit which will be distributed between Mudarib and Rab-ul-Maal at the agreed ratio.

If no balance is left, Mudarib will not get anything. If the principal amount is not recovered fully, then the profit shared by Mudarib and Rab-ul-Maal during the term of Mudarabah will be withdrawn to pay the principal amount to Rab-ul-Maal. The balance will be profit, which will be distributed between Mudarib and Rab-ul-Maal. In this case too, if no balance is left, Mudarib will not get anything.

Uses Of Musharakah / Mudarabah

These modes can be used in the following areas (or can replace them according to Shariah rules).

Asset Side Financing

- Short/medium/long - term financing
- Project financing
- Small & medium enterprises setup financing
- Large enterprise financing
- Import financing
- Import bills drawn under import letters of credit
- Inland bills drawn under inland letters of credit
- Bridge financing
- LC without margin (for Mudarba)
- Export financing (Pre-shipment financing)
- Working capital financing

Liability Side Financing

- For current /saving/mahana amdani/investment accounts (deposit giving Profit based on Musharkah / Mudarabah - with predetermined ratio)
- Inter- Bank lending / borrowing
- Term Finance Certificates & Certificate of Investment
- T-Bill and Federal Investment Bonds / Debenture.
- Securitization for large projects
- Certificate of Investment based on Murabahah (e.g: Meezan Riba Free)

Chapter 12

Diminishing Musharakah

Concept of Diminishing Musharakah

Another form of Musharakah, developed in the near past, is 'Diminishing Musharakah'. According to this concept, a financier and his client participate either in the joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share until all the units of the financier are purchased by the client. so as to make him the sole owner of the property, or the commercial enterprise, as the case may be.

The Diminishing Musharakah based on the above concept has taken different shapes in different transactions. Some examples are given below:

1. It has been used mostly in house financing. The client wants to purchase a house for which he does not have adequate funds. He approaches the financier who agrees to participate with him in purchasing the required house. For instance, 20% of the price is paid by the client and 80% of the price by the financier thus, the financier owns 80% of the house while the client owns 20%. After purchasing the property jointly, the client uses the house for his residential requirement and pays rent to the financier for using his share in the property. At the same time, the share of financier is further divided into eight equal units, each unit representing 10% ownership of the house. The client promises to the financier that he will purchase one unit after three months. Accordingly, after the first term of three months the client purchases one unit of the share of the financier by paying 1/10th of the price of the house. This reduces the share of the financier from 80% to 70%. Hence, the rent payable to the financier is also reduced to that extent. At the end of the second term, he purchases another unit thereby increasing his share in the property to 40% and reducing the share of the financier to 60% and consequently reducing the rent to that proportion. This process goes on in the same fashion until after the end of two years, the client purchases the whole share of the financier reducing the share of the financier to 'zero' and increasing his own share to 100%.

   This arrangement allows the financier to claim rent according to his proportion of ownership in the property and at the same time allows him periodical return of a part of his principal through purchases of the units of his share.

2. 'A' wants to purchase a taxi to use it for offering transport services to passengers and to earn income through fares recovered from them, but he is short of funds. 'B' agrees to participate in the purchase of the taxi, therefore, both of them purchase a taxi jointly. For instance, 80% of the price is paid by 'B' and 20% is paid by 'A'. After the taxi is purchased, it is employed to provide transport to the passengers whereby the net income of Rs. 1000/- is earned on daily basis. Since 'B' has 80% share in the taxi, it is agreed that 80% of the fare will be given to him and the rest of 20% will be retained by 'A' who has a 20% share in the taxi. It means that Rs. 800/- is earned by 'B' and Rs. 200/- by 'A' on daily basis. At the same time the share of 'B' is further divided into eight units. After three months 'A' purchases one unit from the share of 'B'. Consequently the share of 'B' is reduced to 70% and share of 'A' is increased to 30% meaning thereby that as from that date 'A' will be entitled to Rs. 300/- from the daily income of the taxi and 'B' will earn Rs. 700/-. This process will go on until after the expiry of two years, the whole taxi will be owned by 'A' and 'B' will take back his original investment along with income distributed to him as aforesaid.

3. 'A' wishes to start the business of ready-made garments but lacks the required funds for that business. 'B' agrees to participate with him for a specified period, say two years. 40% of the investment is contributed by 'A' and 60% by 'B'. Both start the business on the basis of Musharakah. The proportion of profit allocated for each one of them is expressly agreed upon. But at the same time 'B's share in the business is divided into six equal units and 'A' keeps purchasing these units on gradual basis until after the end of two years 'B' comes out of the business, leaving its exclusive ownership to 'A'. Apart from periodical profits earned by 'B', he gains the price of the units of his share which, in practical terms, tend to repay to him the original amount invested by him.

   Analyzed from the Shariah point of view this arrangement is composed of different transactions, which come to play their role at different stages. Therefore, each one of the foregoing three forms of diminishing Musharakah is discussed below in the light of the Islamic principles:

House Financing on the basis of Diminishing Musharakah

The proposed arrangement is composed of the following transactions:

1. To create joint ownership in the property (Shirkat-ul-Milk).
2. Giving the share of the financier to the client on rent.
3. Promise from the client to purchase the units of share of the financier.
4. Actual purchase of the units at different stages.
5. Adjustment of the rental according to the remaining share of the financier in the property.

Steps in detail of the arrangement

i) The first step in the above arrangement is to create a joint ownership in the property. It has already been explained in the beginning of this chapter that 'Shirkat-ul-Milk' (joint ownership) can come into existence in different ways including joint purchase by the parties. All schools of Islamic jurisprudence have expressly allowed this type of contract. Therefore no objection can be raised against creating this joint ownership.

ii) The second part of the arrangement is that the financier leases his share in the house to his client and charges rent from him. This arrangement is also above board because there is no difference of opinion among the Muslim jurists in the permissibility of leasing one's undivided share in a property to his partner. If the undivided share is leased out to a third party its permissibility is a point of difference between the Muslim jurists. Imam Abu Hanifa رحمة اللّٰه عليه and Imam Zufar رحمة اللّٰه عليه are of the view that the undivided share cannot be leased out to a third party, while Imam Malik and Imam Shafi'i, Abu Yusuf and Muhammad Ibn Hasan hold that the undivided share can be leased out to any person. But so far as the property is leased to the partner himself, all of them are unanimous on the validity of 'Ijarah'.

iii) The third step in the aforesaid arrangement is that the client purchases different units of the undivided share of the financier. This transaction is also allowed. If the undivided share relates to both land and building, the sale of both is allowed according to all the Islamic schools. Similarly if the undivided share of the building is intended to be sold to the partner, it is also allowed unanimously by all the Muslim jurists. However, there is a difference of opinion if it is sold to a third party.

It is clear from the foregoing three points that each one of the transactions mentioned above is allowed, but the question is whether this transaction may be combined in a single arrangement. The answer is that if all these transactions have been combined by making each one of them a condition to the other, then this is not allowed in Shariah, because it is a well settled rule in the Islamic jurisprudence that one transaction cannot be made a pre-condition for another.

However, the proposed scheme suggests that instead of making two transactions conditional to each other, there should be one sided promise from the client, firstly, to take share of the financier on lease and pay the agreed rent, and secondly, to purchase different units of the share of the financier of the house at different stages. This leads us to the fourth step, which is the enforceability of such a promise.

iv) It is generally believed that a promise to do something creates only a moral obligation on the promisor, which cannot be enforced through courts of law. However, there are a number of Muslim jurists who declare that promises are enforceable, and the court of law can compel

> the promisor to fulfill his promise, especially, in the context of commercial activities. Some Maliki and Hanafi jurists can be cited, in particular, who have declared that the promises can be enforced through courts of law in cases of need. The Hanafi jurists have adopted this view with regard to a particular sale called 'bai-bilwafa'. This bai-bilwafa is a special arrangement of sale of a house whereby the buyer promises to the seller that whenever the latter gives him back the price of the house, he will resell the house to him. This arrangement was in vogue in countries of central Asia, and the Hanafi jurists have declared that if the resale of the house to the original seller is made a condition for the initial sale, it is not allowed. However, if the first sale is affected without any condition, but after affecting the sale the buyer promises to resell the house whenever the seller offers to him the same price, this promise is acceptable and it creates not only a moral obligation, but also an enforceable right of the original seller. The Muslim jurists allowing this arrangement have based their view on the principle that "the promise can be made enforceable at the time of need".
>
> Even if the promise has been made before affecting the first sale, after which the sale has been affected without a condition, it is also allowed by certain Hanafi jurists.

One may raise an objection that if the promise of resale has been taken before entering into an actual sale, it practically amounts to putting a condition on the sale itself, because the promise is understood to have been entered into between the parties at the time of sale, and even if the sale is without an express condition, it should be taken as conditional because a promise in an express term has preceded it.

This objection can be answered by saying that there is a big difference between putting a condition in the sale and making a separate promise without making it a condition. If the condition is expressly mentioned at the time of sale, it means that the sale will be valid only if the condition is fulfilled, meaning thereby that if the condition is not fulfilled in future, and the present sale will become void. This makes the transaction of sale contingent on a future event, which may or may not occur. It leads to uncertainty (Gharar) in the transaction, which is totally prohibited in Shariah.

Conversely, if the sale is without any condition, but one of the two parties has promised to do something separately, then the sale cannot be held contingent or conditional with fulfillment of the promise. It will take effect irrespective of whether or not the promisor fulfills his promise. Even if the promisor backs out of his promise, the sale will remain effective. The most the promisee can do is to compel the promisor through court of law to fulfill his promise and if the promisor is unable to fulfill the promise, the promisee can claim actual damages he has suffered because of the default.

This makes it clear that a separate and independent promise to purchase does not render the original contract conditional or contingent. Therefore, it

can be enforced.

On the basis of this analysis, diminishing Musharakah may be used for House Financing with following conditions:

a) The agreement of joint purchase, leasing and selling different units of the share of the financier should not be tied-up together in one single contract. However, the joint purchase and the contract of lease may be joined in one document whereby the financier agrees to lease his share, after joint purchase to the client. This is allowed because, as explained in the relevant chapter, Ijarah can be affected for a future date. At the same time the client may sign one-sided promise to purchase different units of the share of the financier periodically and the financier may undertake that when the client will purchase a unit of his share, the rent of the remaining units will be reduced accordingly.

b) At the time of the purchase of each unit, sale must be affected by the exchange of offer and acceptance at that particular date.

c) It will be preferable that the purchase of different units by the client is affected on the basis of the market value of the house as prevalent on the date of purchase of that unit, but it is also permissible that a particular price is agreed in the promise of purchase signed by the client as it is a Shirkat Ul Milk transaction and partnership is only over the assets and not in the business.

Diminishing Musharakah for carrying business of services

The second example given earlier for diminishing Musharakah is the joint purchase of a taxi for using it as a hired vehicle to earn income. This arrangement consists of the following elements:

a) Creating joint ownership in a taxi in the form of Shirkat-ul-Milk. As already stated, this is allowed in Shariah.

b) Musharakah in the income generated through the services of the taxi. It is also allowed, as mentioned earlier in this chapter.

c) Purchase of different units of the share of the financier by the client. This is again subject to the conditions already explained in the case of House financing. However, there is a slight difference between House financing and the arrangement suggested in this second example. The taxi, when used as a hired vehicle, normally depreciates in value over time, therefore, depreciation in the value of the taxi must be kept in mind while determining the price of different units of the share of the financier.

Diminishing Musharakah in Trade

The third example of diminishing Musharakah as given above is that the financier contributes 60% of the capital for starting a business of ready-made garments, for example. This arrangement is composed of two elements only:

1) In the first place, the arrangement is simply a Musharakah whereby two partners invest different amounts of capital in a joint enterprise. This is obviously permissible subject to the conditions of Musharakah already spelled out earlier in this chapter.

2) Purchase of different units of the share of the financier by the client. This may be in the form of a separate and independent promise by the client. The requirements of Shariah regarding this promise are the same as explained in the case of House financing with one very important difference. Here the price of units of the financier cannot be fixed in the promise to purchase, because if the price is fixed before hand at the time of entering into Musharakah, it will practically mean that the client has ensured the principal invested by the financier with or without profit, which is strictly prohibited in the case of Musharakah. Therefore, there are two options for the financier about fixing the price of his units to be purchased by the client. One option is that he agrees to sell the units on the basis of valuation of the business at the time of the purchase of each unit. If the value of the business increases, the price will be higher and if it decreases the price will be lower. Such valuation may be carried out in accordance with the recognized principles through the experts, whose identity may be agreed upon between the parties when the promise is signed. The second option is that the financier allows the client to sell these units to any body else at whatever price he can, but at the same time he offers a specific price to the client, meaning thereby that if he finds a purchaser of that unit at a higher price, he may sell it to him, but if he wants to sell it to the financier, the latter will be agreeable to purchase it at the price fixed by him before hand.

Although both these options are available according to the principles of Shariah, the second option does not seem to be feasible for the financier, because it would lead to injecting new partners in the Musharakah which will disturb the whole arrangement and defeat the purpose of Diminishing Musharakah in which the financier wants to get his money back within a specified period. Therefore, in order to implement the objective of Diminishing Musharakah, only the first option is practical.

Uses:

- All Purchase of Fixed Assets
- House Financing
- Plant & Factory Financing
- Car / Transport Financing
- Project Financing of fixed assets.

Chapter 13

Murabahah

Murabahah is one of the most commonly used modes of financing by Islamic Banks and financial institutions.

Definition

Murabahah is a particular kind of sale where the seller expressly mentions the cost of the sold commodity, and sells it to another person by adding some profit thereon. Thus, Murabahah is not a loan given on interest; it is a sale of a commodity for hand to hand/deferred price.

The Bai' Murabahah in banks involve purchase of a commodity by a bank on behalf of a client and its resale to the latter on cost-plus-profit basis. Under this arrangement the bank discloses its cost and profit margin to the client. In other words, rather than advancing money to a borrower, which is how the system would work in a conventional banking agreement, the bank will buy the goods from a third party and sell those goods to the customer at a pre-agreed price.

Murabahah is a mode of financing as old as Musharakah. Today in Islamic banks world-over approximately 66% of all investment transactions are through Murabahah.

Difference between Murabahah and Sale

A simple sale in Arabic is called Musawamah - a bargaining sale without disclosing or referring to what the cost price is. However when the cost price is disclosed to the client it is called Murabahah. A simple Murabahah is one where there is cash payment i.e payment is made at the time of sale and Murabahah Mua'jjal is one on deferred payment basis i.e payment is made after few days of sale

Arguments against Murabahah

Differences between Murabaha and Conventional Financing:

Conventional Financing	Murabaha
1. Qard Based Contract	1. A sale transaction
2. Compensation in t he form of Interest, since any benefit over loan is Interest	2. Compensation in the form of Price of goods
3. Bank does not assume the ownership and risk of the assets	3. The ownership and risk of the asset are borne by the bank.
4. Charges penalty in case of late payment	4. No penalty can be charged in case of late payment.

Basic rules for Murabahah

Following are the rules governing a Murabahah transaction:

1. The subject of sale must exist at the time of the sale. Thus anything

that does not exist at the time of sale cannot be sold and its non-existence makes the contract void.

2. The subject matter should be in the ownership of the seller at the time of sale. If he sells something that he himself has not acquired then the sale becomes void.

3. The subject of sale must be in physical or constructive possession of the seller when he sells it to another person. Constructive possession means a situation where the possessor has not taken physical delivery of the commodity yet it has come into his control and all rights and liabilities of the commodity are passed on to him including the risk of its destruction.

4. The sale must be instant and absolute. Thus a sale attributed to a future date or a sale contingent to a future event is void. For example, 'A' tells 'B' on 1st January that he will sell his car on 1st February to 'B', the sale is void because it is attributed to a future date.

5. The subject matter should be a property having value. Thus a good having no value cannot be sold or purchased.

6. The subject of sale should not be a thing used for an un-Islamic purpose.

7. The subject of sale must be specifically known and identified to the buyer. For Example, 'A' owner of an apartment building says to 'B' that he will sell an apartment to 'B'. Now the sale is void because the apartment to be sold is not specifically mentioned or pointed to the buyer.

8. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.

9. The certainty of price is a necessary condition for the validity of the sale. If the price is uncertain, the sale is void.

10. The sale must be unconditional. A conditional sale is invalid unless the condition is recognized as a part of the transaction according to the usage of the trade.

Step by step Murabahah Financing

1. The client and the institution sign an overall agreement whereby the institution promises to sell and the client promises to buy the commodity from time to time on an agreed ratio of profit added to the cost. This agreement may specify the limit up-to which the facility may be availed.
2. An agency agreement is signed by both the parties, in which the institution appoints the client as his agent for purchasing the commodity on its behalf.

3. The client purchases the commodity on behalf of the institution and takes possession as the agent of the institution.

4. The client informs the institution that it has purchased the commodity and simultaneously makes an offer to purchase it from the institution.

5. The institution accepts the offer and the sale is concluded whereby ownership as well as risk is transferred to the client.

All the above conditions are necessary to affect a valid Murabahah. If the institution purchases the commodity directly from the supplier, it does not need any agency agreement.

The most essential element of the transaction is that the commodity must remain in the risk of the institution during the period between the third and the fifth stage.

The above is the only way by which this transaction is distinguished from an ordinary interest-based transaction.

Practical Example

ABC & Co is a exporter of Rice. The company purchases paddy rice from local suppliers and after processing the rice the company exports it to different countries. The company has a working capital requirement of Rs 100 Million for purchase of paddy rice from the suppliers. The company approached an Islamic Bank for granting finance facility of Rs 100 million.

Islamic Bank offers facility of Murabaha to the customer through which Bank and the Customer signs a Master Agreement to sell and purchase Paddy rice on Murabaha basis from time to time as per the conditions of the Agreement. Upon requirement for the purchase of paddy rice the customer gives an Order to the bank to supply paddy rice worth of Rs 10 million to the company on Murabaha basis. Upon receipt of the request from the Customer, the Bank authorizes the Customer to purchase the paddy rice as an agent of the Bank from the market. Customer negotiates the deal with the M/s Unique Rice trader and intimate the Bank to make Pay Order in the name of M/s Unique Rice Trader.

Bank then issues a Pay Order in the name of M/s Unique Rice trader, which can either be paid directly by the bank to the supplier or the Bank may hand over the Pay Order to the Customer to provide it to Unique trader on behalf of the Bank.
Upon receipt of payment, Unique Rice trader supply the rice to the Customer (the agent of the bank). Immediately upon the receipt of Paddy rice the agent (Customer) intimates the bank about the receipt of rice worth Rs 10 million from the supplier and simultaneously offers to purchase the same rice from the Bank for Rs 10.5 million with deferred payment of 6

months.

The Bank, after verifying the genuiness of the transaction and ensuring that all the basic rules of sale are being fulfilled, accepts the offer of customer. With the acceptance of the Bank the ownership and risk of the rice transfers to the customer and the same rice can now be used by the customer.

However if the same customer would have gone to some conventional Interest based bank for financing the same transaction , then the Conventional bank would have granted a loan of Rs 10 million for a period of 6 months with interest of Rs 0.5 million.

Apparently the end result of both the transactions look similar, where customer ends up paying same amount of money but the underlying transaction for the first transaction is a Sale based Contract, which is allowed in Islam, whereas the contract of Conventional Bank is a loan Contract for which any sort of compensation is not allowed in Islam.

Issues in Murabahah

Following are some of the issues in Murabahah financing:

1. Securities against Murabahah

Payments accruing from the sale are receivables and for this, the client may be asked to furnish a security. It can be in the form of a mortgage or hypothecation or some kind of lien or charge.

2. Guaranteeing the Murabahah

The seller can ask the client to furnish a 3rd party guarantee. In case of default on payment the seller will have recourse to the guarantor who will be liable to pay the amount guaranteed to him.

There are two issues relating to this:

a) The guarantor cannot charge a fee from the original client.
b) However the guarantor can charge for any documentation expenses.

3. Penalty for default

Another issue with Murabahah is that if the client defaults in payment of the price at the due date, the additional price cannot be changed nor can penalty fees be charged.

In order to avoid the adverse consequences, an alternative is that the client may be asked to undertake that if he fails to pay installment on its due date, he will pay certain amount to charity.

For this purpose the bank may maintain a charity fund to be distributed in

charity under the directions of Shariah board of the bank.

4. Rollover in Murabahah

Murabahah transaction cannot be rolled over for a further period as the old contract ends. It should be understood that Murabahah is not a loan rather the sale of a commodity, which is deferred to a specific date. Once this commodity is sold, its ownership transfers from the bank to the client and it is therefore no more a property of the seller. Now what the seller can claim is only the agreed price and therefore there is no question of affecting another sale on the same commodity between the same parties.

5. Rebate on earlier payments

Sometimes the debtors want to pay earlier than maturity to get discounts. Majority of Muslim Scholars including the major schools of thought consider this to be un-Islamic. However if the Islamic bank or financial institution gives somebody a rebate on its own without stipulating it in the contract of Murabaha, it is not objectionable especially if the client is needy. This should not be a regular practice and in no way forms a part of the contract.

6. Calculation of cost in Murabahah

The Murabahah can only be affected when the seller can ascertain the exact cost he has incurred in acquiring the commodity he wants to sell. If the exact cost cannot be ascertained then Murabahah cannot take place. In this case the sale will take place as Musawamah i.e. sale without reference to the cost.

7. Subject matter of the sale

All commodities cannot be the subject matter of Murabahah because certain requirements needs to be fulfilled. The shares of a lawful company can be sold or purchased on Murabahah basis because according to the principles of Islam the shares represent ownership into assets of the company provided all other basic conditions of the transaction are fulfilled. A buy back arrangement or selling without taking their possession is not allowed at all.

Murabahah is not possible on things that cannot become the subject of sale.

Basic mistakes in Murabahah Financing:

Some basic mistakes that can be made in practical implementation of the concept are as follows:

1. The most common mistake is to assume that Murabahah can be used for all types of transactions and financing. This mode can only be used when a commodity is to be purchased by the customer. If funds are required for some other purpose Murabahah cannot be used.

2. The document signed for obtaining funds is for a specific commodity and therefore it is important to certify the subject matter of the Murabahah.

3. In some cases, the sale of commodity to the client is affected before the commodity is acquired from the supplier. This occurs when the various stages of the Murabahah are skipped and the documents are signed all together. It is to be remembered that Murabahah is a package of different contracts and they come into play one after another at their respective stages.

4. It is observed in some financial institutions that Murabahah is applied on already purchased commodities, which is not allowed in Shariah and can only be affected on commodities that are not yet purchased.

5. Both the Customer and the Bank staff must be properly educated, lack of education may cause Shariah Non-Compliance issue.

Risk Management of Murabaha Financing:

Some of the major risk and their Mitigants are as follows:

1) **Product Specific Risk:** In Murabaha Financing, an Islamic Bank should assume the risk of destruction or loss of the assets prior to its sale to the Customer.

   Mitigant: The risk of destruction of assets can be mitigated by obtaining takaful coverage on the assets. Another tool for managing this risk is to minimize the time of ownership by selling the asset to the customer immediately after acquiring the assets.

2) **Credit Risk:** It is the risk pertaining to the default or delay of customer is paying its obligations.

Mitigant:

i) Any Shariah Compliant security can be taken to cover the risk of non-payment or delay in payment
ii) Robust evaluation of customer's business performance and Industry outlook.
iii) Matching the Murabaha financing with the cash cycle of the customer. e.g if a customer sells its goods in the market for a credit of 90 days then tenure for Murabaha financing must be kept around 90 days.

3) Shariah Non-Compliance Risk: This is the risk of Non-compliance of basic Shariah requirements of a Murabaha transaction, which results in the reduction of the income of the bank as non-compliant income may lead to loss of bank's income as banks cannot take income from a non-compliant transactions.

Mitigant:

i) Proper Training of Bank and the customer

ii) Implementing strong control measures in the bank through Policy making
iii) Implement a system of Shariah Audit and Compliance.
iv) Development of easy to understand process flow for each Murabaha financing.

Variants of Murabaha Financing:

On the basis of requirements of customer, numerous variants of Murabaha can be developed. Some of them are as follows:

1) **Advance Payment Murabaha:** In this type of Murabaha structure, bank makes advance payment to supplier of assets and sells these assets to customer after receiving the delivery of assets.

2) **Credit Payment Murabaha:** In this type of Murabaha structure, bank sells the assets to its customer which the bank has purchased on credit from the supplier i.e outflow of funds is made by the bank after certain time of execution of Murabaha sale with the customer and financing is booked prior to disbursement of funds by bank.

3) **Murabaha Pledge:** In this type of Murabaha structure, bank keeps the same goods as pledge which the bank has sold to the customer through a Murabaha transaction.

4) **Murabaha Spot:** In this type of Murabaha structure, the bank does not immediately sell the asset to the customer but keeps the asset in its inventory. The assets held in the inventory of the bank are sold to the customer, as per his requirement against spot payment.

Uses of Murabahah:

Murabahah is being used in following scenarios globally:

Short / Medium / Long Term Finance for:

- Raw material
- Inventory
- Equipment
- Asset financing
- Import financing
- Export financing (Pre-shipment)
- Consumer goods financing
- House financing
- Vehicle financing
- Land financing
- Shop financing
- PC financing
- Tour package financing
- Education package financing

- All other services that can be sold in the form of package (i.e. services like education, medical etc. as a package)
- Securitization of Murabahah agreement (certificate) is allowed at par value only. Other wise certain rules of Islamic Finance must be met.

Bai' Muajjal

Bai' Muajjal is the Arabic acronym for "sale on deferred payment basis". The deferred payment becomes a loan payable by the buyer in a lump sum or installment (as agreed between the two parties). In Bai' Muajjal all those items can be sold on deferred payment basis which come under the definition of capital where quality does not make a difference but the intrinsic value does. Those assets do not come under the definition of capital where quality can be compensated for by the price and Shariah scholars have an 'ijmah' (consensus) that demanding a high price in deferred payment in such a case is permissible.

Conditions for Bai' Muajjal

1. The price to be paid must be agreed and fixed at the time of the deal. It may include any amount of profit without qualms about riba.

2. Complete/total possession of the subject in question must be given to the buyer, while the deferred price is to be treated as debt against the buyer.

3. Once the price is fixed, it cannot be decreased in case of earlier payment nor can it be increased in case of default.

4. In order to secure the payment of price, the seller may ask the buyer to furnish a security either in the form of mortgage or in the form of a tangible item.

5. If the commodity is sold on installments, the seller may put a condition on the buyer that if fails to pay any installment on its due date, the remaining installments will become due immediately.

Accounting Treatment of Murabaha Transactions

Since Murabaha is a Sale transaction and not a loan transaction therefore the accounting treatment of Murabaha must also be different from the loan transaction. Following are the major points which should be considered while devising accounting treatment of Murabaha transactions.

1) Profit Recognition:

In a loan transaction interest income is accrued and recognized by the banks from the date of loan disbursement, but in case of Murabaha transactions the income can only be recognized by the bank only after the asset has been sold to the customer, even though the bank has made advance payment to the supplier or to his agent.

2) Inventory:

The goods purchased by Islamic Banks, before being sold to the customer, must be recorded in the balance sheet of the bank as inventory of the bank. Cost of inventories should comprise all costs of purchases and other costs incurred in bringing the inventories to their present location and condition.

3) Murabaha Receivables:

Unlike a loan transaction, the Murabaha receivable shall be disclosed as Trade debts.

A sample of accounting entries that can be used to record Murbaha transactions is as follows:

1. At the time of payment to the client for the purchase of goods on behalf of bank or directly to the supplier by the bank the transaction will be accounted for as follows:

   January 01, 2011

		Dr	Cr
Dr	Advance Against Murabaha	xxxxx	
Cr	Pay Order / Party Account		xxxxx

2. When bank receives the possession of the goods , the following entries would be passed:

		Dr	Cr
Dr	Inventory	xxxx	
Cr	Advance against Murabaha		xxxx

3. When the purchased goods are sold by the bank to the customer on Murabaha basis, the following entries would be passed.

		Dr	Cr
Dr	Murabaha Financing	xxxx	
Dr	Murabaha Profit Receivable	xxxx	
Cr	Inventory		xxxx
Cr	Deferred Murabaha Income		xxxx

4. If the bank has sold the goods on 12 months deferred period then at the end of each month bank may recognize 1/12th of the income as Income on Murabaha financing. At this stage following entries would be passed.

		Dr	Cr
Dr	Deferred Murabaha Income	xxxx	
Cr	Income on Murabaha Financing		xxxx

And so on this entry will be passed at the end of EACH month till maturity.

In case bank did not receive the possession of the goods by month end and therefore could not execute Murabaha sale with the customer then bank will not accrue income for the month and the above mentioned entry # 4 would NOT be passed. Apart from this, entries number 2, 3 and 4 will also not be passed since bank has not yet possessed the goods.

5. On Maturity of Murabaha transaction i.e. at the time of receiving of final payment following entry would be passed:

   January 01, 2012

Dr	Party Bank A/c	xxxx		
Cr	Murabaha Financing			xxxx
Cr	Murabaha Profit Receivable		xxxx	

Note: The Accounting entries are based upon practice of Meezan Bank Limited. The Accounting treatment may very from Bank to Bank.

Chapter 14

Salam

Glossary

Rabb-us-salam : Buyer

Muslam ilaihi : Seller

Ra's-ul-maal : Cash price

Muslam fihi : Purchased commodity

In Salam, the seller undertakes to supply specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. The payment is at spot but the supply of purchased goods is deferred.

Purpose of use

- This mode of financing can be used by the modern banks and financial institutions especially to finance the agricultural sector.

- To meet the need of small farmers who need money to grow their crops and to feed their family up till the time of harvest. When Allah's messenger declared Riba as haram, the farmers could not take usurious loans. Therefore Holy Prophet allowed them to sell their agricultural products in advance.

- To meet the need of traders for import and export business. Under Salam, it is allowed to sell the goods in advance so that after receiving cash price, they can easily undertake the aforesaid business. Salam is beneficial to the seller as he receives the price in advance and it is beneficial to the buyer also as normally the price in Salam is lower than the price in spot sale.

The permissibility of Salam is an exception to the general rule that prohibits forward sale and therefore it is subject to strict conditions, which are as follows:

Conditions for Salam

1. It is necessary for the validity of Salam that the buyer pays the price in full to the seller at the time of affecting the sale. In the absence of full payment, it will be tantamount to sale of a debt against a debt, which is expressly prohibited by the Holy Prophetﷺ. Moreover the basic wisdom for allowing Salam is to fulfill the "instant need" of the seller. If the full price is not paid in advance, the basic purpose of Salam will not be achieved.

2. Only those goods can be sold through a Salam contract in which the quantity and quality can be exactly specified eg. precious stones cannot be sold on the basis of Salam because each stone differs in quality, size, weight and their exact specification is not possible.

3. Salam cannot be effected on a particular commodity or on a product of a particular field or farm e.g. Supply of wheat of a particular field or the fruit of a particular tree since there is a possibility that the crop is destroyed before delivery and given such possibility, the delivery remains uncertain.

4. All details in respect to quality of goods sold must be expressly specified leaving no ambiguity, which may lead to a dispute.

5. It is necessary that the quantity of the commodity is agreed upon in absolute terms. It should be measured or weighed in its usual measure only, meaning what is normally weighed cannot be quantified and vice versa.

6. The exact date and place of delivery must be specified in the contract.

7. Salam cannot be affected in respect of things, which must be delivered at spot. For example, if gold is purchased in exchange of silver, it is necessary that the delivery of both commodities be simultaneous thus gold or silver cannot become subject matter of Salam if the price is paid in the form of gold/silver.

8. The commodity for Salam contract be available in the market at the time of delivery. This view is as per the rulings of Shaafi, Maliki and Hanbali school of thought.

9. The time of delivery should be at least fifteen days or one month from the date of agreement. Price in Salam is generally lower than the price in spot sale. The period should be long enough to affect prices. But Hanafi Fiqh did not specify any minimum period for the validity of Salam. It is all right to have an earlier date of delivery if the seller consents to it.

10. Since price in Salam is generally lower than the price in spot sale; the difference in the two prices may be a valid profit for the Bank.

11. A security in the form of a guarantee, mortgage or hypothecation may be required for a Salam in order to ensure that the seller delivers.

12. The seller at the time of delivery must deliver commodities and not money to the buyer who would have to establish a special cell for dealing in commodities.

Benefits

There are two ways of using Salam for the purpose of financing:

1. After purchasing a commodity by way of Salam, the financial institution can sell it through a parallel contract of Salam for the same date of delivery. The period of Salam in the second parallel contract is shorter and the price is higher than the first contract. The difference between the two prices shall be the profit earned by the institution. The shorter

the period of Salam, the higher the price and the greater the profit. In this way institutions can manage their short term financing portfolios.

2. The institution can obtain a promise to purchase from a third party. This promise should be unilateral from the expected buyer. The buyer does not have to pay the price in advance. When the institution receives the commodity, it can sell it at a pre-determined price to a third party according to the terms of the promise.

Conditions of Parallel Salam

1. In an arrangement of parallel Salam there must be two different and independent contracts; one where the bank is a buyer and the other in which it is a seller. The two contracts cannot be tied up and performance of one should not be contingent on the other. For example, if 'A' has purchased from 'B' 1000 bags of wheat by way of Salam to be delivered on 31 December, 'A' can contract a parallel Salam with 'C' to deliver to him 1000 bags of wheat on 31 December. But while contracting Parallel Salam with 'C', the delivery of wheat to 'C' cannot be conditioned with taking delivery from 'B'. Therefore, even if 'B' did not deliver wheat on 31 December, 'A' is duty bound to deliver 1000 bags of wheat to 'C'. He can seek whatever recourse he has against 'B', but he cannot rid himself from his liability to deliver wheat to 'C'. Similarly, if 'B' has delivered defective goods, which do not conform to the agreed specifications, 'A' is still obligated to deliver the goods to 'C' according to the specifications agreed with him.

2. A Salam arrangement cannot be used as a buy back facility where the seller in the first contract is also the purchaser in the second. Even if the purchaser in the second contract is a separate legal entity, but owned by the seller in the first contract; it would not be tantamount to a valid parallel Salam agreement. For example, 'A' has purchased 1000 bags of wheat by way of Salam from 'B' - a joint stock company. 'B' has a subsidiary 'C', which is a separate legal entity but is fully owned by 'B'. 'A' cannot contract the parallel Salam with 'C'. However, if 'C' is not wholly owned by 'B', 'A' can contract parallel Salam with it, even if some share-holders are common between 'B' and 'C'.

Some of the risks that are present in Salam Financing for Banks are as follows:

		RISKS	MITIGANTS
1	Delivery Risk	Delay in delivery of goods from the customer.	i) Wait until goods are available. ii) Bank can cancel the contract and recover the Salam Price iii) Bank can agree on replacement of goods provided that the market value of the replaced goods do not exceed the market value of the original goods that were subject matter of Salam.

2	Quality Risk	The Customer delivers defected/inferior goods.	The Bank has the right to reject the delivery or bank can accept the delivery at discounted price.
3	Price Risk	Market price of the subject matter decreases after MBL enters into Salam agreement.	Parralel Slam orpromise to purchase from a 3rd party will mitigate the risk.
4	Storage Risk	The goods once delivered by Customer will be at Bank's risk before the same are sold to the ultimate purchaser	This may be covered through Takaful of the goods and by minimizing the time duration between acceptance of delivery under Salam and delivery to the ultimate purchaser.

Chapter 15

Istisna'

Introduction

Istisna' is a sale transaction where a commodity is transacted before it comes into existence. It is an order to a manufacturer to manufacture a specific commodity for the purchaser. The manufacturer uses his own material to manufacture the required goods.

In Istisna', price must be fixed with the consent of all parties involved. All other necessary specifications of the commodity must also be fully settled.

Cancellation of contract

After giving prior notice, either party can cancel the contract before the manufacturing party has begun its work. Once the work starts, the contract cannot be cancelled unilaterally.

Difference between Istisna' and Salam

Istisna	Salam
The subject on which transaction of Istisna' is based, is always a thing which needs to be manufactured.	The subject may be anything that may or may not need manufacturing.
The price in Istisna' does not necessarily need to be paid in full in advance. It is not necessary to pay the full price even at delivery. It can be deferred to any time according to the agreement of the parties. The payment may also be made in installments.	The price has to be paid in full in advance.
The time of delivery does not have to be fixed in Istisna'.	The time of delivery is an essential part of the contract.
The contract can be cancelled before the manufacturer starts the work.	The contract cannot be cancelled unilaterally.

Difference between Istisna' and Ijarah

Istisna	Ijarah tul Ashkhaas
The manufacturer uses his own material or obtains it to make the ordered goods.	The material is provided by the customer and the manufacturer uses only his labor and skill, that is, his services are hired for a specified fee.
The purchaser has a right to reject the goods after inspection as Shariah permits somebody who purchases a thing not seen by him, to cancel the sale after seeing it. The right of rejection only exists if the goods do not conform to the specifications agreed upon between the parties at the time of contract.	Right of rejection of goods after inspection does not exist.

Time of delivery

As pointed out earlier, it is not necessary in Istisna' that the time of delivery is fixed. However, the purchaser may fix a maximum time for delivery which means that if the manufacturer delays the delivery after the appointed time, he will not be bound to accept the goods or to pay the price.

In order to ensure that the goods are delivered within the specified period, some modern agreements of this nature contain a penal clause to the effect that in case the manufacturer delays the delivery after the appointed time, he shall be liable to pay a penalty which shall be calculated on daily basis. Can such a penal clause be inserted in a contract of Istisna' according to Shariah? Although the classical jurists seem to be silent about this question while they discuss the contract of Istisna', yet they have allowed a similar condition in the case of Ijarah. They say that if a person hires the services of a person to tailor his clothes, the fee may be variable according to the time of delivery. The hirer may say that he will pay Rs. 100/- in case the tailor stitches the clothes within one day and Rs. 80/- in case he prepares them after two days.

On the same analogy, the price in Istisna' may be tied up with the time of delivery, and it will be permissible if it is agreed between the parties that in the case of delay in delivery, the price shall be reduced by a specified amount per day.

Istisna' as a mode of financing

Istisna' may be used to provide financing for house financing. If the client owns a land and seeks financing for the construction of a house, the financier may undertake to construct the house on the basis of an Istisna'. If the client does not own the land and wants to purchase that too, the financier can provide him with a constructed house on a specified piece of land. The financier does not have to construct the house himself. He can either enter into a parallel Istisna' with a third party or hire the services of a contractor (other than the client). He must calculate his cost and fix the price of Istisna' with his client that allows him to make a reasonable profit over his cost. The payment of installments by the client may start right from the day when the contract of Istisna' is signed by the parties. In order to secure the payment of installments, the title deeds of the house or land, or any other property of the client may be kept by the financier as a security until the last installment is paid by the client. The financier will be responsible to strictly conform to the specifications in the agreement for the construction of the house. The cost of correcting any discrepancy would have to be borne by him.

Istisna' may also be used for similar projects like installation of an air conditioner plant in the client's factory, building a bridge or a highway.

The modern BOT (buy, operate and transfer) agreements may be formalized through an Istisna' agreement as well. So, if the government wants to build a highway, it may enter into an Istisna' contract with the builder. The price of Istisna' maybe the right of the builder to operate the highway and collect tolls for a specific period.

Uses of Istisna'

- House financing
- Financing of plant / factory / building.
- Booking of apartments
- BOT arrangements
- Construction of buildings and plants.

Accounting Treatment of Istisna Transactions

Following points must be considered while developing Accounting treatment for Istisna transactions:

1) Profit Recognition

If bank has placed an Order to Manufacture to the customer to provide assets of certain specifications, then income will only be recognized by the bank once the bank has received the delivery of the goods and has also sold these goods in the market.

2) Inventory

The goods that are delivered by the customer, as per the bank's Order to Manufacture, will be recorded in the balance sheet of the bank as the inventory of the bank.

Example:

A sample of accounting entries that can be used to record Istisna transactions is as follows:

1. At the time of payment of Istisna price to the customer i.e at the time of making Order to Manufacture following entries would be passed

January 01, 2011		
Dr Advance Against Istisna	xxxxx	
Cr Pay Order / Party Account		xxxxx

2. When bank receives the possession of the goods , the following entries would be passed.

Dr Inventory	xxxx	
Cr Advance against Istisna		xxxx

3. When the received goods are sold by the bank in the market, the following entries would be passed:

Dr Istisna Financing	xxxx	
Cr Inventory		xxxx

4. At month end following entries would be passed to record the income.

Dr Istisna Profit Recievable	xxxx	
Cr Income on Istisna Financing		xxxx

And so on this entry will be passed at the end of EACH month till maturity.

In case bank did not receive the possession of the goods by month end and therefore could not sell the goods in the market then bank will not accrue income for the month and the above mentioned entry would NOT be passed. Apart from this, entries number 2, 3 and 4 will also not be passed since bank has not yet possessed the goods.

5. On Maturity of Istisna transaction i.e. at the time of receiving of final payment following entry would be passed

Dr	Party Bank A/c	xxxx*	
Cr	Istisna Financing		xxxx
Cr	Istisna Profit Receivable		xxxx

Note: The Accounting entries are based upon practice of Meezan Bank Limited and may very from Bank to Bank.

Risk Mitigation in Istisna:

Some of the risks that are present in Istisna Financing for Banks are as follows:

		RISKS	MITIGANTS
1	Delivery Risk	Delay in delivery of goods from the manufacturer to bank.	Istisna price can be reduced on daily basis to penalize the manufacturer
2	Non-performance	The Manufacturer may not be able to manufacture the goods during assigned time and refuses to carry on the responsibility further.	Bank can terminate the Istisna agreement and demand the price back from the manufacturer. Alternatively, the price may be paid by Bank in installments after being satisfied with the performance.
3	Quality Risk	The Manufacturer delivers defected/ inferior goods.	Bank has the right to reject the goods and demand the price back.
4	Price Risk	Market price of the subject matter decreases after MBL enters into Istisna agreement.	Parallel Istisna or promise to purchase from a 3rd party will mitigate the risk.
5	Storage Risk	The goods once delivered by Manufacturer will be at Bank's risk before the same are sold to the ultimate purchaser	This may be covered through Takaful of the goods and by minimizing the time duration between acceptance of delivery under Istisna and delivery to the ultimate purchaser.

Chapter 16

Istijrar

Istijrar means purchasing goods time to time in different quantities. In Islamic jurisprudence Istijrar is an agreement where a buyer purchases something from time to time; each time there is no offer or acceptance or bargain. There is one master agreement where all terms and conditions are finalized. There are two types of Istijrar:

- Whereby the price is determined after all transactions of purchase are complete.
- Whereby the price is determined in advance but the purchase is executed from time to time.

The first kind is relevant with the Islamic mode of financing. This kind is permissible with certain conditions.

1. In the case where the seller discloses the price of goods at the time of each transaction; the sale becomes valid only when the buyer possess the goods. The amount is paid after all transactions have been completed.
2. If the seller does not disclose each and every time to the buyer the price of the subject matter, but the contractors know that it is being sold on market value and the market value is specified and determined in such a manner that it does not vary and it does not lead to differences of the contractors, then the sale would be void.
3. If at the time of possession, the price of subject matter was unknown or contractors agree that whatever the price shall be, the sale will be executed. However, if there is significant difference in the market price and the agreed price, it may cause conflict. In such a case, at the time of possession, the sale will not be valid. However, at the time of settlement of the payment, the sale will be valid.

The validity will relate to the time of possession. Therefore the ownership of the buyer in the subject matter will be proved from the time of possession. After the payment of price the buyer's usage of the subject matter will be valid from the time of the possession.

Uses of Istijrar

The concept of Istijrar can be applied in Murabaha in the following manner. The bank may use the concept of istijrar for purchase of goods from suppliers

and then to sell on the basis of istijrar with some amount of profit on deferred payment basis. This product will work suitably when the bank purchases the goods directly from the supplier and then sells it to the buyer. Because in this case the goods will be in the ownership as well as in the risk of the bank till he sells them to the buyer, that makes the contract of sale valid and earning profit on such a transaction will be permissible (Halaal). Conversely, if the bank makes him his agent to procure the goods, and he purchases them from time to time and utilize them, then it would not be possible to ascertain the point when the ownership and the risk of the goods passed to the buyer. To make a viable product, following mechanism may be used:

1. The bank enters into an Istijrar agreement with the purchaser to sell different commodities to the extent of some specified (say X amount) limit with a cost plus some profit amount.

2. The purchaser sends a purchase requisition letter to request the purchase of specified commodities.

3. Simultaneously or just after signing the Istijrar agreement with the purchaser, the bank agrees with the supplier either to purchase the goods on normal spot / credit payment basis or the bank may also enter into a parallel istijrar agreement to purchase the goods on market whereby the payment may be made in advance or after the delivery.

4. After receiving the purchase requisition from the customer, the bank sends a purchase requisition letter to the supplier to order him to deliver the goods to the bank or its authorized person from the bank or ask him to deliver them to the purchaser's premises on bank's behalf. After taking possession of the goods and making the supplier its agent to deliver the goods to the customer, the goods will remain in the ownership and risk of the bank.

It should be noted that a template purchase requisition letter should be prepared in such a way that completely mentions the specifications of the goods and a confirmation letter should also be sent from the supplier to the bank and then from a bank to the purchaser describing all details of the goods and their prices, so that there should not be any ambiguity in the subject matter as well as in the price that may leads to dispute.

Chapter 17

Ijarah

(LEASING)

"Ijarah" is a term of Islamic fiqh. Lexically, it means 'to give something on rent'. In the Islamic jurisprudence, the term 'Ijarah' is used for two different situations. In the first place, it means 'to employ the services of a person on wages given to him as a consideration for his hired services." The employer is called 'mustajir' while the employee is called 'ajir', while the wages paid to the ajir are called their 'ujrah'.

Therefore, if A has employed B in his office as a manager on a monthly salary, A is mustajir, and B is an ajir. Similarly, if A has hired the services of a porter to carry his baggage to the airport, A is a mustajir while the porter is an ajir, and in both cases the transaction between the parties is termed as Ijarah-tul-Ashkhas.

The second type of Ijarah relates to the usufructs of assets and properties, and not to the services of human beings. 'Ijarah' in this sense means 'to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.' In this case, the term 'Ijarah' is analogous to the English term 'leasing'. Here the lessor is called 'Mujir', the lessee is called 'mustajir' and the rent payable to the lessor is called 'ujrah'. However, there are many differences between leasing contract of Conventional Bank and Ijara, which will be discussed in detail.

Basic Rules

Transferring of usufruct not ownership

In leasing, an owner transfers its usufruct to another person for an agreed period, at an agreed consideration.

Subject of lessee

Should be valuable, identified and quantified.

All consumable things cannot be leased out

The corpus of the leased property remains in the ownership of the seller, and only its usufruct is transferred to the lessee. Thus, anything which cannot be used without consuming, cannot be leased out. For example money, wheat etc.

All liabilities of ownership is borne by lessor

As the corpus of the leased property remains in the ownership of the lessor, all the liabilities emerging from the ownership shall be borne by the lessor.

Period of lease

- The period of lease must be determined in clear terms.
- It is necessary for a valid lease that the leased asset is fully identified by the parties.

Lease for specific purpose

The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement. However, if no such purpose is specified in the agreement, the lessee can use it for whatever purpose it is used in the normal course.

Lessee as Ameen

- The lessee is liable to compensate the lessor for every harm to the leased asset caused by any misuse or negligence.

- The leased asset shall remain in the risk of the lessor throughout the lease period in the sense that any harm or loss caused by the factors beyond the control of the lessee shall be borne by the lessor.

Lease of jointly owned property

- A property jointly owned by two or more persons can be leased out, and the rental shall be distributed between all joint owners according to the proportion of their respective shares in the property.

- A joint owner of a property can lease his proportionate share only to his co-sharer, and not to any other person

Determination of Rental

- The rental must be determined at the time of contract for the whole period of lease.

- It is permissible that different amounts of rent are fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of affecting a lease. If the rent for a subsequent phase of the lease period has not been determined or has been left at the option of the lessor, the lease is not valid.

- The determination of rental on the basis of the aggregate cost incurred in the purchase of the asset by the lessor, as normally done in financial leases, is not against the rules of Shariah, if both parties agree to it, provided that all other conditions of a valid lease prescribed by the Shariah are fully adhered to.

- The lessor cannot increase the rent unilaterally, and any agreement to this effect is void.
- The rent or any part thereof may be payable in advance before the delivery of the asset to the lessee, but the amount so collected by the lessor shall remain with him as 'on account' payment and shall be adjusted towards the rent after its being due.
- The lease period shall commence from the date on which the leased asset has been delivered to the lessee.
- If the leased asset has totally lost the function for which it was leased, the contract will stand terminated.
- The rentals can be used on or benchmarked with some Index as well. In this case the ceiling and floor rentals can be identified for validity of lease.

Lease as a mode of financing

Lease is not originally a mode of financing. It is simply a transaction meant to transfer the usufruct of a property from one person to another for an agreed period against an agreed consideration. However, certain financial institutions have adopted leasing as a mode of financing instead of long term lending on the basis of interest.

This transaction of financial lease may be used for Islamic financing, subject to certain conditions. It is not sufficient for this purpose to substitute the name of 'interest' by the name of 'rent' and replace the name of 'mortgage' by the name of 'leased asset'. There must be a substantial difference between leasing and an interest-bearing loan. That will be possible only by following all the Islamic rules of leasing, some of which have been mentioned earlier.

To be more specific, some basic differences between the contemporary financial leasing and the actual leasing allowed by the Shariah are indicated below:

Conventional Leasing	Ijara
1. The asset to be leased is not owned by the Bank	1. The asset to be leased is owned by the bank
2. The bank is not responsible for any loss to the asset	2. The bank bears the risk of loss of asset if such loss is not caused by the negligence of the customer.
3. Rent is charged and demanded prior to delivery of the asset	3. No rent can be charged and demanded prior to delivery of the asset
4. The conventional lease agreements give unilateral right to Bank to terminate the Lease Agreement without any reason	4. Since Ijarah is a binding agreement therefore neither party can terminate it without mutual consent unless if there is a breach of contract by either party.
5. Penalty on late payment is charged	5. Penalty on late payment cannot be charged

The commencement of lease

Unlike the contract of sale, the agreement of Ijarah can be effected for a future date. Hence, it is different from Murabahah.

In most cases of the 'financial lease' the lessor i.e. the financial institution purchases the asset through the lessee himself. The lessee purchases the asset on behalf of the lessor who pays its price to the supplier, either directly or through the lessee. In some lease agreements, the lease commences on the very day on which the price is paid by the lessor, irrespective of whether the lessee has effected payment to the supplier and taken delivery of the asset or not. It may mean that lessee's liability for the rent starts before the lessee takes delivery of the asset. This is not allowed in Shariah, because it amounts to charging rent on the money given to the customer, which is nothing but interest.

Rent should be charged after the delivery of the leased asset

The correct way, according to Shariah, is that the rent will be charged after the lessee has taken delivery of the asset, and not from the day the price has been paid. If the supplier has delayed the delivery after receiving the full price, the lessee should not be liable for the rent of the period of delay.

Different relations of the parties

It should be clearly understood that when the lessee himself has been entrusted with the purchase of the asset intended to be leased, there are two separate relations between the institution and the client, which come into operation one after the other. In the first instance, the client is an agent of the institution to purchase the asset on latter's behalf. At this stage, the relation between the parties is nothing more than the relation of a principal and his agent. The relation of lessor and lessee has not yet come into operation.

The second stage begins from the date when the client takes delivery from the supplier. At this stage, the relation of lessor and lessee comes to play its role. These two capacities of the parties should not be mixed up or confused with each other. During the first stage, the client cannot be held liable for the obligations of a lessee. In this period, he is responsible to carry out the functions of an agent only. But when the asset is delivered to him, he is liable to discharge his obligations as a lessee.

Difference between Murabahah and leasing

In Murabahah, as mentioned earlier, actual sale should take place after the client takes delivery from the supplier, and the previous agreement of Murabahah is not enough for effecting the actual sale. Therefore, after taking possession of the asset as an agent, he is bound to give intimation to the institution, and make an offer for the purchase from him. The sale takes place after the institution accepts the offer.

The procedure in leasing is different, and a little shorter. Here the parties

need not affect the lease contract after taking delivery. If the institution, while appointing the client its agent, has agreed to lease the asset with effect from the date of delivery, the lease will automatically start on that date without any additional procedure. There are two reasons for this difference between Murabahah and leasing:

a) It is a necessary condition for a valid sale that it should be affected instantly. Thus, a sale attributed to a future date is invalid in Shariah. But leasing can be attributed to a future date. Therefore, the previous agreement is not sufficient in the case of Murabahah, while it is quite enough in the case of leasing.

b) The basic principle of Shariah is that one cannot claim a profit or a fee for a property the risk of which was never borne by him. Applying this principle to Murabahah, the seller cannot claim a profit over a property, which never remained under his risk for a moment. Therefore, if the previous agreement is held to be sufficient for affecting a sale between the client and the institution, the asset shall be transferred to the client simultaneously when he takes its possession, and the asset shall not come into the risk of the seller even for a moment. That is why the simultaneous transfer is not possible in Murabahah, and there should be a fresh offer and acceptance after the delivery.

In leasing, however, the asset remains under the risk and ownership of the lessor throughout the leasing period, because the ownership has not been transferred. Therefore, if the lease period begins right from the time when the client has taken delivery, it does not violate the principle mentioned above.

Expenses consequent to ownership

- As the lessor is the owner of the asset and he has purchased it from the supplier through his agent, he is liable to pay all the expenses incurred in the process of its purchase and its import to the country of the lessor for example expenses of freight and customs duty etc.

- He can, of course, include all these expenses in his cost and can take them into consideration while fixing the rentals, but as a matter of principle, he is liable to bear all these expenses as the owner of the asset. Any agreement to the contrary, as is found in the traditional financial leases, is not in conformity with Shariah.

Lessee as Ameen/ Liability of the parties in case of loss to the asset

As mentioned in the basic principles of leasing, the lessee is responsible for any loss caused to the asset by his misuse or negligence. He can also be made liable to the wear and tear, which normally occurs during its use. But he cannot be made liable to a loss caused by the factors beyond his control. The agreements of the traditional 'financial lease' generally do not differentiate between the two situations. In a lease based on the Islamic principles, both the situations should be dealt with separately.

Variable Rentals in Long Term Leases

In the long-term lease agreements, it is mostly not in the benefit of the lessor to fix one amount of rent for the whole period of lease, because the

market conditions change from time to time. In this case, the lessor has two options:

(a) He can contract lease with a condition that the rent shall be increased according to a specified proportion (e.g. 5%) after a specified period (like one year).

(b) He can contract lease for a shorter period after which the parties can renew the lease at new terms and by mutual consent, with full liberty to each one of them to refuse the renewal, in which case the lessee is bound to vacate the leased property and return it back to the lessor.

These two options are available to the lessor according to the classical rules of Islamic Fiqh. However, some contemporary scholars have allowed, in long-term leases, to tie up the rental amount with a variable benchmark, which is so well known and well defined that it does not leave room for any dispute. For example, it is permissible according to them to provide in the lease contract that in case of any increase in the taxes imposed by the government on the lessor, the rent will be increased to the extent of same amount. Similarly it is allowed by them that the annual increase in the rent is tied up with the rate of inflation. Therefore if there is an increase of 5% in the rate of inflation, it will result in an increase of 5% in the rent as well.

Based on the same principle, some Islamic banks use the rate of interest as a benchmark to determine the rental amounts. They want to earn the same profit through leasing as is earned by the conventional banks through advancing loans on the basis of interest. Therefore, they want to tie up the rentals with the rate of interest and instead of fixing a definite amount of rental, they calculate the cost of purchasing the lease assets and want to earn through rentals an amount equal to the rate of interest. Therefore, the agreement provides that the rental will be equal to the rate of interest or to the rate of interest plus something. Since the rate of interest is variable, it cannot be determined for the whole lease period. Therefore, these contracts use the interest rate of a particular country (like LIBOR) as a benchmark for determining the periodical increase in the rent. This arrangement has been criticized on two grounds:

a) The first objection raised against it is that, by subjecting the rental payments to the rate of interest, the transaction is rendered akin to an interest based financing. This objection can be overcome by saying that, as fully discussed in the case of Murabahah, the rate of interest is used as a benchmark only. So far as other requirements of Shariah for a valid lease are properly fulfilled, the contract may use any benchmark for determining the amount of rental. The basic difference between an interest based financing and a valid lease does not lie in the amount to be paid to the financier or the lessor. The basic difference is that in the case of lease, the lessor assumes the full risk of the corpus of the leased asset. If the asset is destroyed during the lease period, the lessor will suffer the loss. Similarly, if the leased asset looses its usufruct without

any misuse or negligence on the part of the lessee, the lessor cannot claim the rent, while in the case of an interest-based financing, the financier is entitled to receive interest, even if the debtor did not at all benefit from the money borrowed. So far as this basic difference is maintained, (i.e. the lessor assumes the risk of the leased asset) the transaction cannot be categorized as an interest-bearing transaction, even though the amount of rent claimed from the lessee is equal to the rate of interest.

It is thus clear that the use of the rate of interest merely as a benchmark does not render the contract invalid as an interest - based transaction. It is, however, advisable at all times to avoid using interest even as a benchmark, so that an Islamic transaction is totally distinguished from an un-Islamic one, having no resemblance of interest whatsoever.

b) The second objection to this arrangement is that the variations of the rate of interest being unknown, the rental tied up with the rate of interest will imply Jahalah and Gharar which is not permissible in Shariah. It is one of the basic requirements of Shariah that the parties must know the consideration in every contract when they enter into it. The consideration in a transaction of lease is the rent charged from the lessee, and therefore it must be known to each party right at the beginning of the contract of lease. If we tie up the rental with the future rate of interest, which is unknown, the amount of rent will remain unknown as well. This is the Jahalah or Gharar, which renders the transaction invalid.

Responding to this objection, one may say that the Jahalah has been prohibited for two reasons:

- It may lead to dispute between the parties. This reason is not applicable here, because both parties have agreed with mutual consent upon a well-defined benchmark that will serve as a criterion for determining the rent, and whatever amount is determined, based on this benchmark, will be acceptable to both parties. Therefore, there is no question of any dispute between them.

- The second reason for the prohibition of Jahalah is that it renders the parties susceptible to an unforeseen loss. It is possible that the rate of interest, in a particular period, zooms up to an unexpected level in which case the lessee will suffer. It is equally possible that the rate of interest zooms down to an unexpected level, in which case the lessor may suffer. In order to meet the risks involved in such possibilities, it is suggested by some contemporary scholars that the relation between rent and the rate of interest is subjected to a limit or ceiling. For example it may be provided in the base contract that the rental amount after a given period, will be changed according to the change in the rate of interest, but it will in no case be higher than 15% or lower than 5% of the previous monthly rent. It will mean that if the increase in the

rate of interest is more than 15%, the rent will be increased only up to 15%. Conversely, if the decrease in the rate of interest is more than 5%, the rent will not be decreased to more than 5%.

In our opinion, this is the moderate view, which takes care of all the aspects involved in the issue.

Penalty for Late Payment of Rent

In some agreements of financial leases, a penalty is imposed on the lessee in case he delays the payment of rent after the due date. This penalty, if meant to add to the income of the lessor, is not warranted by the Shariah. The reason is that the rent after it becomes due, is a debt payable by the lessee, and is subject to all the rules prescribed for a debt. A monetary charge from a debtor for his late payment is exactly the riba prohibited by the Holy Quran. Therefore, the lessor cannot charge an additional amount in case the lessee delays payment of the rent.

Penalty of late payment is given to charity

In order to avoid the adverse consequences, an alternative may be resorted to. The lessee may be asked to undertake that, if he fails to pay rent on its due date, he will pay certain amount to a charity. For this purpose the financier/lessor may maintain a charity fund where such amounts may be credited and disbursed for charitable purposes, including advancing interest-free loans to the needy persons. The amount payable for charitable purposes by the lessee may vary according to the period of default and may be calculated at per cent, per annum basis. The agreement of the lease may contain the following clause for this purpose:

"The Lessee hereby undertakes that, if he fails to pay rent at its due date, he shall pay an amount calculated at ....% p.a. to the charity Fund maintained by the Lessor which will be used by the Lessor exclusively for charitable purposes approved by the Shariah and shall in no case form part of the income of the Lessor."

This arrangement, though does not compensate the lessor for his opportunity cost of the period of default, yet it may serve as a strong deterrent for the lessee to pay the rent promptly.

Termination of Lease

If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent. In some agreements of the 'financial lease' it has been noticed that the lessor has been given an unrestricted power to terminate the lease unilaterally whenever he wishes, according to his sole judgment. This is again contrary to the principles of Shariah.

In some agreements of the 'financial lease' a condition has been found to the effect that in case of the termination of lease, even at the option of the lessor, the lessee shall pay the rent of the remaining lease period.

This condition is obviously against Shariah and the principles of equity and justice. The basic reason for inserting such conditions in the agreement of

lease is that the main concept behind the agreement is to give an interest-bearing loan under the ostensible cover of lease. That is why every effort is made to avoid the logical consequences of the lease contract.

Naturally, such a condition cannot be acceptable to Shariah. The logical consequence of the termination of lease is that the lessor should take the asset back. The lessee should be asked to pay the rent as due up to the date of termination. If the termination has been effected due to the misuse or negligence on the part of the lessee, he can also be asked to compensate the lessor for the loss caused by such misuse or negligence. But he cannot be compelled to pay the rent of the remaining period.

Insurance of the assets

If the leased property is insured under the Islamic mode of Takaful, it should be at the expense of the lessor and not at the expense of the lessee, as is generally provided in the agreements of the current 'financial leases'.

The residual value of the leased asset

Another important feature of the modern 'financial leases' is that after the expiry of the lease period, the corpus of the leased asset is normally transferred to the lessee. As the lessor already recovers his cost along with an additional profit thereon, which is normally equal to the amount of interest which could have been earned on a loan of that amount advanced for that period, the lessor has no further interest in the leased asset. On the other hand, the lessee wants to retain the asset after the expiry of the leased period.

For these reasons, the leased asset is generally transferred to the lessee at the end of the lease, either free of any charge or at a nominal token price. In order to ensure that the asset will be transferred to the lessee, sometimes the lease contract has an express clause to this effect. Sometimes this condition is not mentioned in the contract expressly; however, it is understood between the parties that the title of the asset will be passed on to the lessee at the end of the lease term. This condition, whether it is express or implied, is not in accordance with the principles of Shariah. It is a well-settled rule of Islamic jurisprudence that one transaction cannot be tied up with another transaction so as to make the former a pre-condition for the other. Here the transfer of the asset at the end has been made a necessary condition for the transaction of lease that is not allowed in Shariah.

The original position in Shariah is that the asset shall be the sole property of the lessor, and after the expiry of the lease period, the lessor shall be at liberty to take the asset back, or to renew the lease or to lease it out to another party, or sell it to the lessee or to any other person. The lessee cannot force him to sell it to him at a nominal price, nor can such a condition be imposed on the lessor in the lease agreement. But after the lease period expires, and the lessor wants to give the asset to the lessee as a gift or to sell it to him, he can do so by his free will.

However, some contemporary scholars, keeping in view the needs of the

Islamic financial institutions, have come up with an alternative. They say that the agreement of Ijarah itself should not contain a condition of gift or sale at the end of the lease period. However, the lessor may enter into a unilateral promise to sell the leased asset to the lessee at the end of the lease period. This promise will be binding on the lessor only. The principle, according to them, is that a unilateral promise to enter into a contract at a future date is allowed whereby the promisor is bound to fulfill the promise, but the promisee is not bound to enter into that contract. It means that he has an option to purchase, which he may or may not exercise. However, if he wants to exercise his option to purchase, the promisor cannot refuse it because he is bound by his promise. Therefore, these scholars suggest that the lessor, after entering into the lease agreement, can sign a separate unilateral promise whereby he undertakes that if the lessee has paid all the amounts of rentals and wants to purchase the asset at a specified mutually acceptable price, he will sell the leased asset to him for that price. Once the lessor signs this promise, he is bound to fulfill it and the lessee may exercise his option to purchase at the end of the period, if he has fully paid the amounts of rent according to the agreement of lease.

Leasing for permissible (Halal) or impermissible usage

It is a brief abstract of an article written by grand Mufti of Pakistan, Mufti Muhammad Shafi about leasing or Selling a property/asset that could be used for Haram purposes.

Its brief description is as follows:

A: If a person sells or leases such property or goods that cannot be used but for Haram purpose, then its contract of sale or lease would be invalid and the seller or lessor would be sinner.

B: If a person sells or leases such a property or goods that can be used in Halal or Haram purposes, and the seller/lessor does not know the exact purpose of the buyer/lessee of purchase or getting on lease, then it would be Halal to sell or Lease.

C: If a person sells or leases such a property or goods that can be used in Halal or Haram purposes, and the seller/lessor knows that he would use it only for Haram purpose, then the contract of Sale/Lease would be valid, however, the buyer/lessee would commit a sin of Karaha (Karahat/disliking). It means that the seller or lessor should avoid to sell or lease them to that person.

Now a question arises that what kind of Karaha would be involved here? Al Karaha Al tahreemiyyah or Al Karaha At tanzihiyyah. (The first one means it is so detested or disliked that it has been very near to Haram. And the second one means that it is not so disliked as the former one, but it is not preferable).

To answer this question, Islamic jurists opined that if a property that is being sold or leased can be used for the both Haram and Halal purposes,

but their manufacturing or building is more suitable for Haram purpose, then it would be Makrooh Al Tahreemi to be sold and leased, otherwise, it would be Makrookh Al Tanzeehi (the second kind).

Based on these principles if the property is built in such a manner that it would be more suitable to use it for theatre purposes, then it is not preferable to sell or lease them, otherwise, it would be an act of sin.

However, if any property can be used for the both purposes equally, and seller or lessor knows that the buyer or lessee would use it for Haram purpose, then its sale or lease would be valid, but not preferable.

Therefore, the buildings or land should not be sold or leased to a party that uses it for haram purposes, in any above mentioned two scenarios.

Accounting Treatment of Ijarah

Following general guidelines must be followed while developing accounting treatment for Ijara transactions:

1) The asset that is given on lease, must be recorded in the balance sheet of the Bank

2) Ijara Income can not be recognized by the Bank before the execution of Ijarah Agreement with the customer.

3) Ijarah income will be recognized over the term of Ijarah on Straight line basis.

4) Costs, including depreciation, incurred in earning the ijarah (lease) income are recognized as an expense.

Chapter 18

Ijarah Wa Iqtina

(Leasing And Promise To Gift)

In Islamic Shariah, it is allowed that instead of sale, the lessor signs a separate promise to gift the leased asset to the lessee at the end of the lease period, subject to his payment of all amounts of rent. This arrangement is called 'Ijarah wa iqtina. It has been allowed by a large number of contemporary scholars and is widely acted upon by the Islamic banks and financial institutions. The validity of this arrangement is subject to two basic conditions:

a) The agreement of Ijarah itself should not be subjected to signing this promise of sale or gift but the promise should be recorded in a separate document.

b) The promise should be unilateral and binding on the promisor only. It should not be a bilateral promise binding on both parties because in this case it will be a full contract affected to a future date, which is not allowed in the case of sale or gift.

Sub-Lease

If the leased asset is used differently by different users, the lessee cannot sub-lease the leased asset except with the express permission of the lessor. If the lessor permits the lessee for subleasing, he may sub-lease it. If the rent claimed from the sub-lessee is equal to or less than the rent payable to the owner / original lessor, all the recognized schools of Islamic jurisprudence are unanimous on the permissibility of the sub lease. However, the opinions are different in case the rent charged from the sub-lessee is higher than the rent payable to the owner. Imam Shafi and some other scholars allow it and hold that the sub lessor may enjoy the surplus received from the sub-lessee. This is the preferred view in the Hanbali School as well. On the other hand, Imam Abu Hanifah is of the view that the surplus received from the sub-lessee in this case is not permissible for the sub-lessor to keep and he will have to give that surplus in charity. However, if the sub-lessor has developed the leased property by adding something to it or has rented it in a currency different from the currency in which he himself pays rent to the owner/the original lessor, he can claim a higher rent from his sub-lessee and can enjoy the surplus.

Although the view of Imam Abu Hanifah is more precautious which should be acted upon to the best possible extent, in cases of need the view of Shafai and Hanbali schools may be followed because there is no express prohibition in the Holy Quran or in the Sunnah against the surplus claimed from the lessee. Ibn Qudamah has argued for the permissibility of surplus on forceful grounds.

Assigning of the Lease

The lessor can sell the leased property to a third party whereby the relation of lessor and lessee shall be established between the new owner and the lessee. However, the assigning of the lease itself (without assigning the ownership in the leased asset) for a monetary consideration is not permissible.

The difference between the two situations is that in the later case the ownership of the asset is not transferred to the assignee, but he becomes entitled to receive the rent of the asset only. This kind of assignment is allowed in Shariah only where no monetary consideration is charged from the assignee for this assignment. For example, a lessor can assign his right to claim rent from the lessee to his son, or to his friend in the form of a gift. Similarly, he can assign this right to any one of his creditors to set off his debt out of the rentals received by him. But if the lessor wants to sell this right for a fixed price, it is not permissible, because in this case the money (the amount of rentals) is sold for money, which is a transaction subject to the principle of equality. Otherwise it will be tantamount to a riba transaction, hence prohibited.

How to Operate Islamic Leasing as a mode of financing

The lease purchase or lease that ends with possession is a new mode innovated by the Islamic banks. What distinguishes this transaction is that the bank does not hold assets on its own, instead it purchases the asset on request from its customer who is interested to own an asset through lease that ends with possession. At the end of the lease period, ownership is transferred to the lessee through a separate contract.

The bank mostly calculates total rentals on the basis of the cost of asset plus the profit. Rentals are payable over a period of time as agreed between the bank and the customer.

In practice, there are two basic kinds, through which the asset becomes the property of the lessee at the end of the lease period.
The first kind: A lease contract with a promise to grant the asset to the lessee after paying all the rental. The grant must be obtained in a separate contract.
The second kind: A lease contract with a promise to sell the asset to the lessee in exchange for a nominal or actual price, the lessee pays at the end of the lease period in addition to paying all the rental installments agreed upon.

How to Operate Islamic Leasing as a mode of financing

1. The purchase contract of assets

The bank: In pursuance of the customer's desire to draw a contract of lease ending with ownership, the bank purchases the asset from the seller, pays the price and gets its possession.

The seller: Agrees on the sale, signs the bill and agrees with the bank about the place of delivery.

2. Delivery and receipt of the Asset:

The seller: Delivers the asset to the bank directly or to any party designated by the bank in the contract.

The bank: Authorizes its customer to receive the asset and demands a notification of arrival and satisfaction of the required specifications.

3. The Ijarah/Lease contract:

The bank: Leases the asset to the customer and separately promises customer the possession of the asset if he pays all the rental (a promise to grant or a promise to sell for a nominal or actual price).

The lessee: pays the rental at the agreed upon periods.

4. Transfer of ownership:

The bank: after the end of the lease period and after the lessee pays all the rentall due, the bank assigns the asset to the benefit of the lessee as a grant or sale as promised.

The lessee: ownership of the asset transfers to the lessee.

Areas Of Applications

The Islamic banks use the area of application purchase especially real estate, computers, machinery and equipment. By so doing the Islamic banks give their customers a freedom of choice to acquire the assets they need from the sources they select in the light of their experience and personal evaluation.

The lessee in this case enjoys the possession and use of the asset during the lease period and it is certain that ownership of the asset will be transferred to him it at the end of the lease period. The bank also, retains the ownership of the asset and it assigns it to the lessee only on receipt of rental installments agreed upon.

Chapter 19

Tawarruq

Tawarruq means to buy on credit and sell at spot value. This transaction is now a days being used by many Islamic banks for liquidity management and as a mode of financing especially for personal financing and credit cards. The following list summarizes a research paper of my honorable father Justice Muhammad Taqi Usmani, which describes his point of view regarding this mode of financing.

1. Tawarruq is an arrangement whereby a person, in need of liquidity, purchases a commodity from a seller on credit at a higher price. The person who acquires liquidity in this way is called 'mutawarriq'.

2. The difference between "inah and tawarruq" is that 'mutawarriq' sells the commodity to a third party, while in "inah" the buyer resells it to the same seller from whom he had bought the commodity.

3. There are two versions reported from Imam Ahmad Ibn Hanbal about the permissibility of 'tawarruq'. Majority of the Hanbali jurists has preferred the version according to which 'tawarruq' is permissible. However, Ibn Taimiyyah رحمة الله عليه and Ibn Qayyim رحمة الله عليه have held 'tawarruq' as impermissible.

4. The Shafi'i jurists have allowed 'inah', and therefore it seems that 'tawarruq' is permissible with them with a greater force.

5. Maliki jurists are very strict about 'inah', but it appears from their books that they do not see a problem in 'tawarruq'.

6. Some Hanafi jurists of later days have held that 'tawarruq' is "inah", hence makrooh. But majority of the Hanfi jurists have preferred the view of Ibn-ul-Humam that "inah" is restricted to the situation where the commodity comes back to the original seller but where the commodity is sold in the market, the transactions are valid and permissible. However, lending money (without interest) is more preferable.

7. Thus the preferred view in all the four schools of Islamic fiqh is that tawarruq is permissible. However, lending (without interest) is more advisable.

8. This is the position with retard to the original concept of tawarruq, but the ruling may change if the transaction is infiltrated by some other elements.

9. If the bank appoints the mutawarriq himself as its agent to purchase the commodity on behalf of the bank, then to sell it to himself, this transaction is invalid. However, if the bank appoints him as an agent only for the purchase of a commodity on behalf of the bank, then once it is purchased, the bank itself sells it to Muta Wariq through a proper contract with offer and acceptance, the transaction is valid, but not advisable.

10. If the 'mutawarriq' after purchasing the commodity from the bank, appoints the bank his agent to sell it in the market and this agency is stipulated in the contract of sale as a condition, the translation is not valid. However, if the agency was not a condition in the sale contract, and it has been affected after unconditioned sale, the transaction is valid, but not advisable.

11. If 'tawarruq' is carried out through the international commodity exchange, it is vulnerable to many violations of Shariah, because many conditions of a valid Islamic sale may be lacking.

12. However, if all the condition of a valid sale, fully discussed in the proper, are properly observed, the transaction may be valid, but its extensive use is not advised.

Note: This chapter is based on the arabic article are written by Justice (Retd) Mufti Taqi Usmani Sb. The Name of the paper is الصكوك و تطبيقاتها المعاصرة

Chapter 20

Islamic Banking Framework Comparison with Conventional Banks

Islamic banking & finance - Global growth trends

Islamic Banking and finance growth has generated considerable interest in the financial world in recent years. The concept of Islamic banking has received encouraging response from different corners of the globe as one discovers its ideological dimensions and practical significance. Given its ability to offer innovative financial solutions for basic financial needs in under-served markets especially in the Muslim worlds to complex financial requirement of the modern times, it is seen as a socially responsible and ethical banking model with considerable growth potential. In the Muslim world and increasingly in the West, significant segments of the institutional and retail markets are choosing Islamic finance for their financing and investment needs. Islamic financial system also draws it strength form it being asset backed nature and directly linkage to the real economic transactions and avoidance of any element of interest and speculative activity.

Understanding the difference:

When we look at the differences between Islamic Financial Institutes and the Interest-based conventional Institutes, we find out that the differences are on three levels:

1. Conceptual & Socio-religious level
2. Business model & Governing framework
3. Product Level Implementation

Without a clear understanding of these differences, some people, even experts tend to make a common mistake of equating Islamic banks with other conventional banks with mere change of name

Key differences between Islamic banks & conventional interest based banks

At Conceptual & Socio-Religious level	
- Islamic banks (IB) are not money lending institutes but they work as a trading/investment house. - Islamic banks work under the socio-religious guidelines that prohibit charging and paying interest and avoid all impermissible transactions like gambling, speculation, short selling & Sale of debts & receivables. - Islamic banks do not permit financing to industries which can cause harm to the society such as alcohol, tobacco etc.	- Conventional Interest based banks (CB) are in the business of lending & borrowing money based on interest. - In CB we see no such restrictions. Interest is the back-bone of this system and short sale, sale of debts and speculative transactions are common. - In CBs all type of industries are financed, only businesses deemed illegal by law of land are not supported.

At Business Model & Governing Framework	
- IBs business model is based on trade, thus IBs need to actively participate in trade and production process and activities. - IBs have a strong Shariah governing framework in terms of Shariah Advisor &/or Shariah Supervisory Board, which approves the transactions & product in the light of the Shariah rulings	- On the other hand, generally CBs did not involve themselves in trade and business as they act only as a money lender. - In CBs no such framework is present and actually it is a key litmus test to judge the claim of those who fails to see differences between IBs & CBs
Product Level implementation	
- Islamic banking products are usually asset backed & involve trading of assets, renting of asset and participation on profit & loss basis. - IBs recognize loan as a non commercial and exclude it from the domain of commercial transaction. Any loan given by IBs must be interest free.	- CBs treat money as a commodity and lend it against interest as its compensation - In CBs almost all the financing & deposit side products are loan based.

In a Conventional Bank the relation ship between the bank and the customer is of Creditor and Debtor and any benefit available to either party falls under the ambit of Interest since it is a gain on Debt/Loan. In Islamic Banking , the relationship between bank and customer differs as per the modes of Finance and the nature of the facility. In Sale Based transaction modes Islamic Banks and the customer assumes the role of Seller and Buyer respectively and any benefit available to either party is profit on Sale Transaction. In Rental based modes the relationship between bank and customer is of Lessor and Lesssee respectively and any benefit available to bank is in the form of Rents. In Participation based modes the relationship between Bank and Customer is of partnership and the gain taken by either party is Profit on Musharakah. In Service based modes the relationship between Islamic Banks and Customer is of Mustajir (Service Provider) and Ajeer (To whom service is given) respectively and gets remuneration in the form of fees (Ujrat). A Comparison of differences in roles between customer and Bank in an Islamic and Conventional Bank is highlighted in the following table

Nature of roles between Bank and Customer in Conventional Banks				
	Conventional Bank		Islamic Bank	
	Role (Bank-Customer)	**Compensation**	**Role (Bank-Customer)**	**Compensation**
Deposit	Debtor-Creditor	Interest	Mudarib-Rab ul Maal	Profit on Mudarbahul Maal
Finance	Creditor-Debtor	Interest	Seller- Buyer	Price (Thaman)
			Lessor-Lessee	Rent
			Partners	Profit
			Agent-principal	Fee

As evident from the above table Conventional Banks only gets compensation in the form of Interest,they do not assume risk of any trade based activities whereas as per Shariah "No gain can be taken without Risk" therefore when Islamic Bank gets compensation (reward) in the form of price or rent or profit in participation, it assumes full risk of the asset in a Sale/Rent transaction and full risk of the performance of business and its assets in a participation based transaction.

Product wise Comparasion of Conventional Bank and Islamic Bank

The conventional banking, which is interest based, performs the following major activities:

1. Deposit creation
2. Financing (Refer to section IV)
3. Agency services
4. Issuing LGs
5. Advisory services
6. Other related services

We now would like to make a comparison of these activities with Islamic concept of banking:

Deposits (The liability side)

Deposit - of Conventional Bank qard (loan) not amanah (Trust)

The common misconception regarding "deposit" is that it is a form of amanah (security/trust). However, according to Shariah definition, deposit has more resemblance to qard (loan) than amanah. This conclusion is based on the fact that in Islam an item is termed as amanah, if it bears all the features of amanah. Deposits cannot be termed amanah, as they do not have two of its special features, i.e.

- Amanah cannot be used by the bank for its business or benefit.
- The bank cannot be liable in case of any damage or loss to the amanah resulting from circumstances beyond its control.

Whereas in banks, deposits are primarily placed to earn profit, which is only possible when the bank uses these deposits to invest in other business. Hence deposits do not fulfill the first condition of amanah, which says that it should not be used by the caretaker for his own business or benefit.

Secondly, the bank is held 100% responsible for these deposits in all circumstances even in case of loss or damage to the bank. This feature releases deposits from the ruling of amanah where the assets will not be returned in case of any damage to the asset resulting from circumstances beyond caretaker's control. According to this justification, all three kinds of deposit namely current accounts, fixed deposits and saving accounts are not amanah. They are all governed by qard.

One school of thought says that only fixed deposit and saving accounts fall under the laws of qard but current account is governed by amanah. However, this is also not correct because the bank is as much liable to current account holders as its PLS account holders and is called the "guarantor" in fiqh terminology. Due to this feature, current account is also governed by qard.

The depositors are not interested in terminology but the end-result of holding an account. Therefore if a bank does not offer security to the assets, the depositors under normal circumstance will never keep their assets at such a bank. Similarly if the depositors are told that the status of their account will that be of amanah and in case of any loss to the assets, without any negligence of the bank, will not be returned to them, not a single person would put his asset in the bank. Therefore the bank provides the security to the assets, which the depositors themselves want.

We therefore conclude that the main intention of the depositors is not to put the assets in banks as amanah; rather as qard by having collateral security by appointing the bank as guarantor.

Example of Sayyidnna Zubair bin Awwam رضی اللہ تعالیٰ عنہ

"Hazrat Zubair bin Awwam رضی اللہ تعالیٰ عنہ was famous for his honesty and trustworthiness. Prominent people used to leave with him their properties in trust. Based on their needs they would also withdraw all or part of their properties. It has been reported in Al Bukhari and Tabaqaat-e-Ibn-e-Saad in respect of Hazrat Zubair bin Awwan رضی اللہ تعالیٰ عنہ that declined to accept such property as amanah (trust) but rather accepted them as qard (loan)"

The reason for this action on his part was his fear that the property may be lost and it may be suspected that he was neglectful in its safekeeping. As such, he decided to consider it a loan so that the depositor felt more comfortable. Another reason for it was that it could become possible for him to employ these funds for trading and earn profit out of them. The loan amount calculated at 2.2 million at the time of his death by his son Syedna Abdullah bin Zubair رضی اللہ تعالیٰ عنہ was specified as qard not amanah. He also used the term loan while instructing his son before his death "Son, dispose off my property to settle the loans".

Conclusion

From the above discussion, we come to the conclusion that all three forms of bank deposits are governed by the law of qard as a consequence of which the account holder may withdraw only the assets deposited. Any increase on it will be interest. It has already been discussed in the chapter of commercial interest that if the purpose of the lender is business or security and not providing financial assistance, then to get an excess amount is also interest, which is prohibited in Islam just like usury.

It is also clear that there is a consensus of Muslim scholars on the point that the transactions in Fixed Deposit and Savings Account is prohibited because

the bank pays excess to their account holders over their actual capital, which is interest. The Islamic Fiqh Academy Jeddah in their 2nd session has further endorsed such transactions as interest based transaction. Therefore, it is illegal for a Muslim to keep their deposits in such accounts. As far as the current account is concerned, the bank does not pay any excess (interest) over the actual capital, therefore, holding such an account is allowed.

To sum up, in the above discussion it is concluded that, profit given on fixed deposit and savings accounts is interest and therefore prohibited. However, if the banking system is based on Islamic principles, Mudarbah/Musharkah can play a very important role. As far as deposits are concerned, Mudarbah/Musharkah is the only instrument in which money can be received from customers meaning that every depositor will become a partner in bank's business through their deposited money. The methodology of Musharakah / Mudarabah based deposit structure is discussed in detail in the chapter titled Musharakah in bank deposit.

Finance Activities:

Asset side of any bank involves Financing activities of the Bank. In Conventional Banks the asset side comprises of loans given to financing entities with different names like Lease, Running Finance, Term Finance etc while the difference among them is only in treatment of security or amortization. Since all the financing products are based on loan therefore the compensation obtained by Conventional Banks from these Financing products falls under the ambit of “Benefit driven from a Loan Transaction”, which is Riba.

Asset side of Islamic Banks:

The asset side of Islamic Banks reflects different products which are based on one of the following modes, which are also discussed in detail in other chapters of this book:

1) Sale Based Modes: Under these modes, an Islamic Bank instead of providing loans, sell asset to the customer and gets the compensation in the form of Price which includes profit of the Bank as a result of the Sale transaction. It is important for any Sale based mode that Islamic Bank must sell the asset to the customer after acquiring the asset and assuming all its risk. Examples of Sale Based modes are Murabaha, Musawamma, Salam, Istisna, Istijrar etc.

2) Participation Based Modes: In Participation based modes Islamic Bank enters into a partnership agreement with the customer over their business and shares the profit or loss as per the actual performance of the business. Examples of Participation based modes are Musharkah an Mudabah.

3) Rental Based Modes: In Rental based modes Islamic Bank acquires the asset and after assuming its ownership and risk, give the asset on rent to the customer for a definite period. Islamic Bank takes its compensation in the form of rent for the usage of the asset.

Agency Based Transaction

A bank under Islamic Shariah can act as an agent (on Al-Wakalah basis) of the customer and can carry out the transaction on his behalf. Moreover it can charge agency fee for the services.

The agency fee can be charged in the following cases:

- Payment / receiving of cash on behalf of the customer
- Inward bill of collection
- Outward bill of collection
- LC opening and acceptance
- Collection of export bills/bills of exchange. In this case the undertaking or guarantee commission and take-up commission can be Islamized. Bank will charge an agency fee for accepting the bills, which is bought at face value.
- Underwriting & IPO services

One major difference between Islamic Banks and Conventional Banks under this category is that Islamic Banks can only carry out those transactions which are Shariah Compliant.

Role of the Bank as Guarantor

The bank or financial institute gives a guarantee on behalf of its customer but according to Shariah, guarantee fee cannot be charged since the act of guaranteeing is a non-compensatory Contract and fees cannot be charged for any Non Compensatory Contract. however a fee can be charged if some additional services are provided to the customer. Some of the common types of Guarantees issued by Banks are as follows:

- Bid Bonds
- Performance Guarantee
- Shipping Guarantee

Advisory Services

Most of the advisory services provided by the financial institutes can be carried out easily in compliance with Shariah as long as the nature of business is halaal:

- Financial advisory services
- Privatization advisory services
- Equity placement
- Merger & acquisition advise
- Venture capital
- Trading (Capital market operations)
- Cash & portfolio management advice
- Brokerage services (Purchase & buying of share of companies involved in halal business, a fee could be charged for it).

Other allowed Islamic financial services & products

- Remittance
- Zakat deduction.
- Sale & purchase of foreign currency
- Sale & purchase of travelers checks (local & foreign currency)
- ATM services
- Electronic online transfer
- Telegraphic transfer (of cash)
- Demand draft
- Pay order
- Lockers & custodial services
- Syndicate funds arrangements services (non-interest or markup based) for some fee.
- Opening of bank account (current & non-interest or no-markup)
- Clearing facility
- Sales & purchase of shares/stock (of companies involved in halal activities)
- Collection of dividends
- Electronic banking window
- Telephone banking.

NEW CHALLENGES FOR THE INDUSTRY

With all the success and growth – Islamic Banking Industry is still in its childhood stage and there is a long way to go. This industry has to overcome many challenges in order to achieve a larger market share and sustain its growth.

Some of the challenges that the Islamic banking industry faces today includes:

- Lack of awareness & skepticism at different levels – including investors, bankers, regulators, researchers & customers.
- Being a new industry, a major challenge in its growth is the worldwide shortage of trained Human Resource in Islamic banking & finance.
- Limited number of Shariah Scholars that create over-reliance and raise questions about Shariah compliance of the institutes involved.
- Focus efforts needed for New Product Development & Research.
- Solutions for Liquidity Management & creation of Islamic Inter-bank Market.
- Absence of a separate Regulatory, Legal & Risk Management framework to cater the specific need of Islamic banking Institutes.

Chapter 21

Musharakah In Bank Deposits

An important value of an Islamic society is mutual dealing. It also refers to deposits in banks. The operation of fixed deposits and savings account in Islamic banks will be different from conventional banks because the Islamic banks will be based on Musharakah (combination of Shirkah & Mudarabah) in which like conventional banks, people will invest in two ways:

1. Participation in setting up the bank like any other company by joint investment and the participants will be called the "shareholders". They will have a partnership (Shirkah) effected by a mutual contract since they have used their capital and deed on the bank; and

2. Participation by opening their account in fixed deposit and savings account and participants will be called the "account holders". These will not be the actual owner or shareholders of the bank - rather partners in profit only, meaning that they will have a contract of Mudarabah

The status of the bank or the shareholders will be that of a Mudarib and the account holders will be Rubb-ul-mal. The contract known as Musharakah will be a combination of Shirkah and Mudarabah. This is the reason why the profit ratio of depositors is less than the actual shareholders and the depositors will not have any voting power or the right of management because they are not involved in the deed but has only supplied the capital. This kind of dual relationship is not uncommon in Islamic Fiqh. Therefore, if the Mudarib (Bank or the shareholders) wants to merge his assets with the assets of depositor, it is allowed in which case he will be regarded as owner of half the assets and Mudarib of the other half. This has already been discussed at length in chapter 11 on Musharakah.

In the previous chapter, following facts have been established:

1. The actual status of deposits in conventional bank is debt and not amanah.

2. The excess paid on loan is interest, not profit.

3. If a bank is operating on Islamic principles, the bank and the depositor will have a partnership through a contract of Shirkah or Mudarabah in which case the depositor's capital will not be regarded as loan.

4. The shareholders will act as Rubb-ul-mal as well as Mudarib.

5. The depositors will only act as Rubb-ul-mal.

6. Fixed deposit and saving account will be converted into Mudarabah account where the distribution of profit for each partner will be determined in proportion to the actual profit accrued to the business and not according to a fixed ratio or in proportion to the capital invested by him. Fixing lump sum amount is not allowed or any rate of profit tied up with any investment.

7. The entire set up of the bank is on Musharakah basis where the relationship of the bank and shareholders is through partnership agreement (Shirkah) because they are participating in labor as well as investment and the relationship between the bank and depositors is only that of Mudarabah because they have only invested without participating in labor. Therefore this combination of Shirkah and Mudarabah is called Musharakah in modern terminology.

Distribution Of Profit Under Musharakah Agreement

The distribution of profit will be done according to the rules of Musharakah. Before we begin the summary of the distribution of profit, it is found appropriate to mention here that the conventional banks do not pay interest to current account holders. Therefore there is no need to convert the operation of current account into any Islamic mode of financing. However the distribution of profit to the rest of the partners and account holders will be made on the following rules governing Musharakah:

It is not a condition for the final distribution of profit that all assets are liquid rather the profit and loss is calculated on the basis of evaluation of assets. In case of loss, each partner shall suffer the loss exactly according to the ratio of his investment and in case of profit; the profit will be distributed according to the agreed ratio between the partners. It should be taken into account that both parties are free to determine any ratio of profit of the bank as the manager (Mudarib), therefore it can be agreed mutually that Rubb-ul-mal will have a higher profit margin and Mudarib lower. However as a shareholding partner, the share of profit of the Mudarib cannot be less than the ratio of his investment since he is the sole provider of labor. Same rule will apply on the operation of Islamic Banks on the basis of Musharakah. The actual shareholders apart from being the manager are also shareholding partners; their ratio of profit cannot be less than their ratio of investment. However their ratio of profit as Mudarib can be determined at whatever rate they please.

The above may be explained in the following illustration:

Suppose the total investment of the bank is Rs.15 million, in which the depositors have invested Rs.10 million on Mudarabah basis and the shareholders as Mudarib have invested Rs.5 million. This means that one third share of the total capital belongs to the shareholders and two third to the depositors. The role of Mudarib in the 2/3rd capital raised by depositors is played by the shareholders, therefore their ratio of profit as manager (Mudarib) can be agreed between themselves through mutual consent but their ratio of profit, as shareholders cannot be less than 1/3rd. If their share

is agreed at less than 1/3rd, it would mean that the depositors' share has exceeded 2/3rd although it has been established that they will not be managing the bank and their share of profit will not exceed their ratio of investment.

If it has been agreed in the above example that the shareholders as managing partners will get 1/3rd of the profit and the rest 2/3rd will be distributed equally between depositors and shareholders as per the Mudarabah contract between them, then if for e.g. the profit amount is Rs.15 lacs then the shareholders will get its 1/3rd i.e. Rs.5 lacs as the investor (Rubb-ul-mal) and half of the 2/3rd profit i.e. Rs.5 lacs as the manager (Mudarib) whereas the other half of the 2/3rd profit will go to the depositor as Rubb-ul-mal.

To sum up, the above procedure can be adopted to run the bank on the principles of Musharakah.

Term Deposit Certificates

In case the bank issues a Term Deposit Certificate on the above mentioned basis, it may have following salient features:

» It should be noted that to issue a negotiable instrument or certificate for the secondary market it is essential to have at least 10% Ijarah assets or any other fixed assets in the portfolio of investment.

» The maturity options available to the customers under this scheme range from one month to a maximum of five years or more.

Profit Distribution Mechanism

In all types of account (Term Deposit Certificates or saving accounts) the following procedure of profit distribution would be adopted to make it Shariah compliant.

- The Investors (Deposit Holders) invest into the pool of Shariah compliant assets of bank on the basis of Mudarabah.
- The investors are Rabbul Mal and the bank is Mudarib (working partner).
- Profit is shared by the both parties in accordance with the ratios of profit.
- In case of loss, it would be shared by the both parties pro rata basis.
- A ratio of profit is fixed for the both parties at the time of investment.
- The ratio of profit is based on gross profit (after deduction of direct expenses at actual)

- After deduction of the direct expenses the remaining profit is shared with the investors and the bank on pre-agreed fixed ratios. The profit of the bank is called Mudarib's profit and the profit of the Depositor is called Rabbul Mal or Investor's profit.

- The Investor's profit is sub divided into various ratios/weightages on the basis of following procedure:

  1) A specific weightage will be allocated to the different types of investors/depositors, according to the maturity and/or investment profiles, at the beginning of each quarter.

  2) Distribution/Declaration of profit at the end of each period will be done in accordance with the pre agreed weightages.

  3) In case bank also invests in the pool of assets, a specific weightage would also be assigned to it and the bank would become a partner/investor as other investors/depositors.

  4) At the end of each period, the profit is distributed/declared according the pre agreed weightages.

  5) The investors are allowed to redeem their investment any time by selling their share to the bank at the value agreed at the time of redemption. (A minimum period can be set by the bank before which no redemption would be allowed).

Running Musharakah Account On The Basis Of Daily Products

Many financial institutions finance the working capital of an enterprise by opening a running account for them from where the clients draw different amounts at different intervals, but at the same time, they keep returning their surplus amounts. Thus the process of debit and credit goes on up to the date of maturity, and the interest is calculated on the basis of daily products.

Can such an arrangement be possible under the Musharakah or Mudarabah modes of financing? Obviously, being a new phenomenon, no express answer to this question can be found in the classical works of Islamic Fiqh. However, keeping in view the basic principles of Musharakah the following procedure may be suggested for this purpose:

- A certain percentage of the actual profit must be allocated for the management.

- The remaining percentage of the profit must be allocated for the investors.

- The loss, if any, should be borne by the investors only in exact proportion of their respective investments.

- The average balance of the contributions made to the Musharakah account calculated on the basis of daily products shall be treated as the share capital of the financier.

- The profit accruing at the end of the term shall be calculated on daily product basis, and shall be distributed accordingly.

If such an arrangement is agreed upon between the parties, it does not seem to violate any basic principle of the Musharakah. However, this suggestion needs further consideration and research by the experts of Islamic jurisprudence. Practically, it means that the parties have agreed to the principle that the profit accrued to the Musharakah portfolio at the end of the term will be divided based on the average capital utilized per day, which will lead to the average of the profit earned by each rupee per day. The amount of this average profit per rupee per day will be multiplied by the number of the days each investor has put his money into the business, which will determine his profit entitlement on daily product basis.

Some contemporary, scholars do not allow this method of calculating profits on the ground that it is just a conjectural method, which does not reflect the actual profits really earned by a partner of the Musharakah. Because the business may have earned huge profits during a period when a particular investor had no money invested in the business at all, or had a very insignificant amount invested, still, he will be treated at par with other investors who had huge amounts invested in the business during that period. Conversely, the business may have suffered a great loss during a period when a particular investor had huge amounts invested in it. Still, he will pass on some of his loss to other investors who had no investment in that period or their size of investment was insignificant.

This argument can be refuted on the ground that it is not necessary in a Musharakah that a partner should earn profit on his own money only. Once a Musharakah pool comes into existence, all the participants, regardless of whether their money is or is not utilized in a particular transaction earn the profits accruing to the joint pool. This is particularly true of the Hanafi School, which does not deem it necessary for a valid Musharakah that the monetary contributions of the partners are mixed up together. It means that if 'A' has entered into a Musharakah contract with 'B', but has not yet disbursed his money into the joint pool, he will be still entitled to a share in the profit of the transactions effected by 'B' for the Musharakah through his own money. Although his entitlement to a share in the profit will be subject to the disbursement of money undertaken by him, yet the fact remains that the profit of this particular transaction did not accrue to his money, because the money disbursed by him at a later stage may be used for another transaction. Suppose 'A' and 'B' entered into a Musharakah to conduct a business of Rs. 100,000/- They agreed that each one of them shall contribute Rs. 50,000/- and the profits will be distributed by them equally. 'A' did not yet invest his Rs. 50,000/- into the joint pool. 'B' found a profitable deal and purchased two air conditioners for the Musharakah for

Rs. 50,000/- contributed by himself and sold them for Rs. 60,000/-, thus earning a profit of Rs. 10,000/-. 'A' contributed his share of Rs. 50,000/- after this deal. The partners purchased two refrigerators through this contribution which could not be sold at a greater price than Rs. 48000/- meaning thereby that this deal resulted in a loss of Rs. 2000/- Although the transaction effected by 'A's money brought loss of Rs. 2000/- while the profitable deal of air conditioners was financed entirely by 'B's money in which 'A' had no contribution, yet 'A' will be entitled to a share in the profit of the first deal. The loss of Rs. 2000/- in the second deal will be set off from the profit of the first deal reducing the aggregate profit to Rs. 8000/-. This profit of Rs. 8000/- will be shared by both partners equally. It means that 'A' will get Rs. 4000/-, even though the transaction effected by his money has suffered a loss.

The reason is that once the parties enter into a Musharakah contract, all the subsequent transactions effected for Musharakah belong to the joint pool, regardless of whose individual money is utilized in them. Each partner is a party to each transaction by virtue of his entering into the contract of Musharakah.

A possible objection to the above explanation may be that in the above example, 'A' had undertaken to pay Rs. 50,000/- and it was known before hand that he would contribute a specified amount to the Musharakah. But in the proposed running account of Musharakah where the partners are coming in and going out every day, nobody has undertaken to contribute any specific amount. Therefore, the capital contributed by each partner is unknown at the time of entering into Musharakah, which should render the Musharakah invalid.

The answer to the above objection is that the classical scholars of Islamic Fiqh have different views about whether it is necessary for a valid Musharakah that the capital is pre-known to the partners. The Hanafi scholars are unanimous on the point that it is not a pre-condition. Al-Kasani, the famous Hanafi jurist, writes:

According to our Hanafi School, it is not a condition for the validity of Musharakah that the amount of capital is known, while it is a condition according to Imam Shafi'i. Our argument is that Jahalah (uncertainty) in itself does not render a contract invalid, unless it leads to disputes. And the uncertainty in the capital at the time of Musharakah does not lead to disputes, because it is generally known when the commodities are purchased for the Musharakah, therefore it does not lead to uncertainty in the profit at the time of distribution." (Badai-us-sanai v.6 p.63)

Therefore, clear from the above that even if the amount of the capital is not known at the time of Musharakah, the contract is valid. The only condition is that it should not lead to the uncertainty in the profit at the time of distribution. Distribution of profit on daily product basis fulfills this condition.

It is true that the concept of a running Musharakah where the partners at times draw some amounts and at other times inject new money and the profits are calculated on daily products basis is not found in the classical books of Islamic Fiqh. But merely this fact cannot render a new arrangement invalid in Shariah, so far as it does not violate any basic principle of Musharakah. In the proposed system, all the partners are treated at par. The profit of each partner is calculated on the basis of the period for which his money remained in the joint pool. There is no doubt in the fact that the aggregate profits accrued to the pool are generated by the joint utilization of different amounts contributed by the participants at different times. Therefore, if all of them agree with mutual consent to distribute the profits on daily products basis, there is no injunction of Shari'ah which makes it impermissible; rather, it is covered under the general guidelines given by the Holy Prophet ﷺ in his famous hadith, as follows:

"المسلمون علي شروطهم الا شرطا حرّم حلالا أو احلّ حرامًا الخ " (كنز العمال , الفصل الأول في الأمان و المعاهدة و الصلح)

"Muslims are bound by their mutual agreements unless they hold a permissible thing as prohibited or a prohibited thing as permissible."

If distribution on daily products basis is not accepted, it will mean that no partner can draw any amount nor can he inject new amounts to the joint pool. Similarly, nobody will be able to subscribe to the joint pool except at the particular dates of the commencement of a new term. This arrangement is totally impracticable on the deposit side of the banks and financial institutions where the accounts are debited and credited by the depositors many times a day. The rejection of the concept of the daily products will compel them to wait for months before they deposit their surplus money in a profitable account. This will hinder the utilization of savings for development of industry and trade, and will keep the wheel of financial activities jammed for long periods. There is no other solution for this problem except to apply the method of daily products for the calculation of profits, and since there is no specific injunction of Shari'ah against it, there is no reason why this method should not be adopted.

Chapter 22

Project Financing

The concept of Musharakah and Mudarabah is based on some basic principles. As long as these principles are fully complied with, the details of their application may vary from time to time. Let us have a look at these basic principles before touching the details:

Basic Principles of Musharakah & Mudarabah for Project Financing:

1. Financing through Musharakah and Mudarabah does never mean the advancing of money. It means participation in the business and in the case of Musharakah, sharing in the assets of the business to the extent of the ratio of financing.

2. An investor/financier must share the loss incurred by the business to the extent of his financing.

3. The partners are at liberty to determine, with mutual consent, the ratio of profit allocated to each one of them, which may differ from the ratio of investment. However, the partner who has expressly excluded himself from the responsibility of work for the business cannot claim more than the ratio of his investment.

4. The loss suffered by each partner must be exactly in the proportion of his investment.

Keeping in view these basic principles project financing is discussed below.

In the case of project financing, the traditional method of Musharakah or Mudarabah can be easily adopted. If the financier wants to finance the whole project, the form of Mudarabah can come into operation. If investment comes from both sides, the form of Musharakah can be adopted. In this case, if the management is the sole responsibility of one party, while the investment comes from both, a combination of Musharakah and Mudarabah can be brought into play according to the rules already discussed.

Since Musharakah or Mudarabah would have been affected from the very inception of the project, no problem with regard to the valuation of capital should arise. Similarly, the distribution of profits according to the normal accounting standards should not be difficult. However, if the financier wants to withdraw from the Musharakah, while the other party wants to continue the business, the latter can purchase the share of the former at an agreed price. In this way the financier may get back the amount he has

invested along with a profit, if the business has earned a profit. The basis for determining the price of his share shall be discussed in detail in later chapter (See chapter working capital financing).

On the other hand, the businessman can continue with his project, either on his own or by selling the first financier's share to some other person who can substitute the first financier. Since financial institutions do not normally want to remain partner of a specific project for good, they can sell their share to other partners of the project as aforesaid. If the sale of the share on one time basis is not feasible for the lack of liquidity in the project, the share of the financier can be divided into smaller units and each unit can be sold after a suitable interval. Whenever a unit is sold, the share of the financier in the project is reduced to that extent, and when all the units are sold, the financier totally comes out of the project.

Financing of a single transaction

Musharakah and Mudarabah can be used more easily for financing a single transaction. Apart from fulfilling the day to day needs of small traders, these instruments can be employed for financing imports and exports. An importer can approach a financier to finance him for that single transaction of import alone on the basis of Musharakah or Mudarabah. The banks can also use these instruments for import financing. If the letter of credit has been opened without any margin, the form of Mudarabah can be adopted, and if the L/C is opened with some margin, the form of Musharakah or a combination of both will be relevant. After the imported goods are cleared from the port, their sale proceeds may be shared by the importer and the financier according to a pre-agreed ratio.

In this case, the ownership of the imported goods shall remain with the financier to the extent of the ratio of his investment. This Musharakah can be restricted to an agreed term, and if the imported goods are not sold in the market up to the expiry of the term, the importer may himself purchase the share of the financier, making himself the sole owner of the goods. However, the sale in this case should take place at the market rate or at a price agreed between the parties on the date of sale, and not at pre-agreed price at the time of entering into Musharakah. If the price is pre-agreed, the financier cannot compel the client / importer to purchase it.

Similarly, Musharakah will be even easier in the case of export financing. The exporter has a specific order from abroad. The price on which the goods will be exported is well known before hand, and the financier can easily calculate the expected profit. He may finance him on the basis of Musharakah or Mudarabah, and may share the amount of export bill on a pre-agreed percentage. In order to secure himself from any negligence on the part of the exporter, the financier may put a condition that it will be the responsibility of the exporter to export the goods in full conformity with the conditions of the L/C. In this case, if some discrepancies are found, the exporter alone shall be responsible, and the financier shall be immune from any loss due to such discrepancies, because it is caused by the negligence of the exporter. However, being a partner of the exporter, the financier will be liable to bear any loss, which may be caused due to any reason other than the negligence or misconduct of the exporter.

Chapter 23

Working Capital Financing

Uses of Musharakah instrument in working capital financing:

Where finances are required for the working capital of a running business, the instrument of Musharakah may be used in the following manner:

1. **The capital of the running business may be evaluated with mutual consent:** The value of the business can be treated as the investment of the person who seeks finance, while the amount given by the financier can be treated as his share of investment. The Musharakah may be affected for a particular period, like one year or six months or less. Both the parties agree on a certain percentage of the profit to be given to the financier, which should not exceed the percentage of his investment, because he shall not work for the business. On the expiry of the term, all liquid and non-liquid assets of the business are again evaluated, and the profit may be distributed on the basis of this evaluation.

   Although, according to the traditional concept, the profit cannot be determined unless all the assets of the business are liquidated, yet the valuation of the assets can be treated as "constructive liquidation" with mutual consent of the parties, because there is no specific prohibition in Shariah against it. It can also mean that the working partner has purchased the share of the financier in the assets of the business, and the price of his share has been determined on the basis of valuation, keeping in view the ratio of profit allocated for him according to the terms of Musharakah.

   For example, the total value of the business of 'A' is 30 units. 'B' finances another 20 units, raising the total worth to 50 units; 40% having been contributed by 'B', and 60% by 'A'. It is agreed that 'B' shall get 20% of the actual profit. At the end of the term, the total worth of the business has increased to 100 units. Now, if the share of 'B' is purchased by 'A', he should have paid to him 40 units, because he owns 40% of the assets of the business. But in order to reflect the agreed ratio of profit in the price of his share, the formula of pricing will be different. Any increase in the value of the business shall be divided between the parties in the ratio of 20% and 80%, because this ratio was determined in the contract for the purpose of distribution of profit.

   Since the increase in the value of the business is 50 units, these 50 units are divided at the ratio of 20:80, meaning thereby that

'B' will have earned 10 units. These 10 units will be added to his original 20 units, and the price of his share will be 30 units.

In the case of loss, however, any decrease in the total value of the assets should be divided between them exactly in the ratio of their investment, i.e., in the ratio of 40/60. Therefore, if the value of the business has decreased, in the above example, by 10 units reducing the total number of units to 40, the loss of 4 units shall be borne by 'B' (being 40% of the loss). These 4 units shall be deducted from his original 20 units, and the price of his share shall be determined as 16 units.

2. **Sharing in the gross profit only:** Financing on the basis of Musharakah according to the above procedure may be difficult in a business having a large number of fixed assets, particularly in a running industry, because the valuation of all its assets and their depreciation or appreciation may create accounting problems giving rise to disputes. In such cases, Musharakah may be applied in another way.

   The major difficulties in these cases arise in the calculation of indirect expenses, like depreciation of the machinery, salaries of the staff etc. In order to solve this problem, the parties may agree on the principle that, instead of net profit, the gross profit will be distributed between the parties, that is, the indirect expenses shall not be deducted from the distributable profit. It will mean that all the indirect expenses shall be borne by the industrialist voluntarily, and only direct expenses (like those of raw material, direct labor, electricity etc.) shall be borne by the Musharakah. But since the industrialist is offering his machinery, building and staff to the Musharakah voluntarily, the percentage of his profit may be increased to compensate him to some extent.

   This arrangement may be justified on the ground that the clients of financial institutions do not restrict themselves to the operations for which they seek finance from the financial institutions. Their machinery and staff etc. is, therefore, engaged in some other business also which may not be subject to Musharakah, and in such a case the whole cost of these expenses cannot be imposed on the Musharakah.

   Let us take a practical example. Suppose a ginning factory has a building worth Rs. 22 million, plant and machinery valuing Rs. 2 million and the staff is paid Rs. 50,000/- per month. The factory sought finance of Rs. 5,000,000/- from a bank on the basis of Musharakah for a term of one year. It means that after one year the Musharakah will be terminated, and the profits accrued up to that point will be distributed between the parties according to the agreed ratio. While determining the profit, all direct expenses will be deducted from the income. The

direct expenses may include the following:

a) The amount spent in purchasing raw material.

b) The wages of the labor directly involved in processing the raw material.

c) The expenses for electricity consumed in the process of ginning.

d) The bills for other services directly rendered for the Musharakah.

So far as the building, the machinery and the salary of other staff is concerned, it is obvious that they are not meant for the business of the Musharakah alone, because the Musharakah will terminate within one year, while the building and the machinery are purchased for a much longer term in which the ginning factory will use them for its own business which is not subject to this one-year Musharakah. Therefore, the whole cost of the building and the machinery cannot be borne by this short-term Musharakah. What can be done at the most is that the depreciation caused to the building and the machinery during the term of the Musharakah is included in its expenses.

But in practical terms, it will be very difficult to determine the cost of depreciation, and it may cause disputes also. Therefore, there are two practical ways to solve this problem.

In the first instance, the parties may agree that the Musharakah portfolio will pay an agreed rent to the client for the use of the machinery and the building owned by him. This rent will be paid to him from the Musharakah fund irrespective of profit or loss accruing to the business.

The second option is that, instead of paying rent to the client, the ratio of his profit is increased.

3. Running Musharakah Account on the Basis of Daily Products: Many financial institutions finance the working capital of an enterprise by opening a running account for them from where the clients draw different amounts at different intervals, but at the same time, they keep returning their surplus amounts. Thus the process of debit and credit goes on up to the date of maturity, and the interest is calculated on the basis of daily products.

Keeping in view the basic principles of Musharakah the following procedure may be suggested for this purpose:

- A certain percentage of the actual profit must be allocated for the management.

- The remaining percentage of the profit must be allocated for

the investors.

- The loss, if any, should be borne by the investors only in exact proportion of their respective investments.

- The average balance of the contributions made to the Musharakah account calculated on the basis of daily products shall be treated as the share capital of the financier.

- The profit accruing at the end of the term shall be calculated on daily product basis, and shall be distributed accordingly.

If such an arrangement is agreed upon between the parties, it does not seem to violate any basic principle of the Musharakah. However, this suggestion needs further consideration and research by the experts of Islamic jurisprudence. Practically, it means that the parties have agreed to the principle that the profit accrued to the Musharakah portfolio at the end of the term will be divided on the capital utilized per day, which will lead to the average of the profit earned by each rupee per day. The amount of this average profit per rupee per day will be multiplied by the number of the days each investor has put his money into the business, which will determine his profit entitlement on daily product basis.

Working Capital Financing Using Murabaha

Working Capital requirements of the company usually comprise of Raw Material, Lobor and Overhead. All those Working Capital requirements which are related to Raw Material can also be financed through Murabaha. In the mode of Murabaha, The Islamic bank would purchase the assets from the supplier either directly or through some agent and after taking possession of the assets, the same assets can be sold to the customer by adding profit over the cost of the purchased assets.

Working Capital Financing Using Istisna

Islamic Bank can also finance the Working Capital requirements of the Company through the mode of Istisna in the following manner.

i) When customer requires funds for its fulfilling its working Capital requirements, then the Islamic Bank will places an Order to Manufacture to the customer to provide finished goods of certain specifications.

ii) After placing the Order, the bank may make the payment of Istisna Price at lump sum or in installments.

iii) After the finished goods are ready for delivery, the bank would

receive the goods from the customer.

iv) After receiving the goods, the bank will sell the goods in the market, either directly or through some agent, to recover its cost price and earn some profit from the transaction.

In extension to the use of Istisna for financing Working Capital requirements, some Islamic Financial Institutions have developed a unique method of "Tijarah" which is based on the concept of "Bai Musawamah". In this concept, the bank will purchase the existing finished goods of the customer on Musawamah Basis and pays the cash to the customer. Upon receiving the ownership of the finished goods the Bank will sell the goods in the market either directly or through some agent to recover its cost price and earn some profit over the transaction.

Chapter 24

Import Financing

Conventional Import Financing

Import Financing is an important aspect of financing by banks. Banks because of variety of reasons finance most of the international trade deals whether they are imports or exports. Usually Traders approach banks for Import Financing because of different issues involved like Foreign Currency transactions, huge payments and tax benefits etc.

Conventional Banks earn in two ways while opening Letter of Credit. These are:

- Service charges for opening an LC (for provision of guarantee)
- Interest charged on the LCs not paid on due date

Both of these types of transactions are not allowed in Shariah. Islam comes up with its own tools to cop with this problem.

Shariah doesn't allow such transactions because Letter of Credit (LC) is basically to guarantee the exporter to pay the purchase price. Accordingly to Shariah no fee or commission can be charged on guarantee (Kafalah). As Kafalah is considered as Aqd Tabarru (Voluntary Contract), therefore no compensation/fee can be harged to issue a guarantee. Secondly, when it is not allowed to ask for any compensation (interest) in advancing any money in the contract of loan, it should also not be allowed to ask any compensation only for undertaking to pay an amount of loan.

Some other issues related to import financing by conventional banking system are:

- Collecting various service charges (such as documentation charges, correspondence, account maintenance, credit assessment charges etc) for the purpose of opening LC is permissible according to Shariah.

- However, the bank may need to charge certain profit in case the importer does not settle the LC on time, or if the Nostro account of the bank is debited before the importer has made payment to the bank.

In this case appropriate Islamic mode need to be used to charge the profit.

Service Charges

The bank may charge service charges for the following services.

- Documentation
- Credit Assessment

- Correspondence
- Account Maintenance Services
- Monitoring Services

However, these service charges should be developed keeping in view the reasonable cost estimates.

The above-mentioned service charges are valid to be charged. However, it should be mentioned in the schedule of charges of Islamic bank that these charges are for the additional services provided by the bank and not for the act of guaranteeing. Some of these charges of those that are time related for services can be charged continuously with time, however, the others should be charged once, where the service does not continue with time.

Import Financing Tools in Islam

Now let's take a look at Islamic modes for import Financing.

Three modes can be used for this purpose:

- Murabahah
- Ijarah
- Musharakah

Each of them is discussed in detail as follows.

Murabahah

Murabahah is generally defined as the sale of a commodity for the price at which the vendor has purchased it, with the addition of a stated profit known to both the vendor and the purchaser. It is a cost-plus-profit contract Islamic financial institutions aim to make use of Murabahah in circumstances where they will purchase raw materials, goods or equipment etc. and sell them to a client at cost, plus a negotiated profit margin to be paid normally by installments. With Murabahah, Islamic financial institutions are no longer to share profits or losses, but instead assume the risk of credit sale.
Standard Murabahah process can be used for financing imports under Murabahah arrangement. In Murabahah, it is extremely necessary to follow the steps as required, so let's take a look at these steps.

Practical Procedure of Murabahah Import Financing

1. The bank will appoint importer as its agent to import the goods on its behalf. In this step, Agreement to Murabahah and an Agency Agreement will be signed.

2. All charges such as insurance, LC opening charges, LC commission, etc. maybe taken as an advance. These will be added to the cost of goods, which are being imported by the importer as bank's agent.

3. The bank's Nostro Account is debited in accordance with the type of LC, i.e. Usance or sight LC.

4. The bank will ask the availability of funds with the importer for

Murabahah transaction. If importer passes the funds immediately, profit will be marginal or a multiple of few days; if importer does not have the funds, rate of profit will be a multiple of credit days given to client. In short, profit will be finalized after checking the timing of funds availability from the client.

5. Once the profit is calculated and agreed, sale price of Murabahah transaction will be calculated. Keeping in view all cost including LC commission, insurance etc.

6. Exporter will ship goods and will send documents to the bank through negotiating bank.

7. After taking delivery or receiving Bill of Lading, Murabahah contract will be executed.

8. The bank will release documents to client.

9. Importer will pay Murabahah price to the bank on the due date.

Now let's see in detail that how Ijarah works with regards to import financing.

Ijarah

Ijarah means a lease contract as well as a hire contract. In the context of Islamic banking it is a lease contract under which the bank of financial institution leases equipment or a building to one of its clients against a fixed charge. Ijarah can also be used to finance imports of fixed assets. The details of Ijarah can be seen in the chapter of Ijarah in this book.

Its step by step details are as follows.

1. The bank will appoint importer as its agent to import the goods on its behalf. In this step, Agreement to Ijarah and an Agency Agreement will be signed.

2. All charges such as insurance, LC opening charges, LC commission, etc. may be taken as security deposit. The bank may also choose to add these charges to the cost of goods while calculating its rental.

3. Exporter will ship goods and will send documents (Bill of Lading) to the bank through negotiating bank.

4. Bank will retire the LC and will handover the B/L to the importer to release the goods.

5. The Importer will release and take delivery of goods, which the bank will enter into an Ijarah agreement with the customer. A specified rental will be agreed at this point in time.

6. After the term of Ijarah agreement is completed, the bank may sell the asset to the importer at an agreed price.

Musharakah or shirkah can be defined as a form of partnership where two

or more persons combine either their capital or labor together, to share the profits, enjoying same rights and benefits. The details of Musharakah can be read in the chapter of Musharakah of this book.

Musharakah

Musharakah can also be used to finance imports, especially imports of commodities, which are sold at certain fixed price in local and international markets such as pulses and other agricultural based products as profit margin can be ascertained.

Step by step process is discussed as follows.

1. The bank and the importer will sign Musharakah Agreement.

2. The purpose of the Musharakah would be to import and sell the commodity in the local market.

3. The bank and the importer may agree on any profit sharing ratio, however, as the importer would be the working partner, his sharing ratio should not be less than his share of investment.

4. The bank may ask the importer to make payment of his share upfront.

5. The bank will open LC in favor of the exporter.

6. Exporter will ship goods and will send documents to the bank through negotiating bank.

7. The bank will make payment to the exporter and will release documents to the importer.

8. Importer will sell the commodity in local market.

9. The bank and importer will calculate profit earned from the transaction, which would be shared between them as per the agreed ratio.

Distribution of Profit

The basis for entitlement to the profits of a Musharakah is capital, active participation in the Musharakah business and responsibility. Profits are to be distributed among the partners in business on the basis of proportions settled by them in advance. The share of every party in profit must be determined as a proportion or percentage. No fixed amount can be settled for any party.

All the jurist are, unanimously, of the view that the loss shall be borne by the partners according to their capitals. In all forms of Musharakah (i.e. limited companies, co-operative societies and partnership) the loss is borne on the basis of capital invested.

Chapter 25

Export Financing

Classification Of Export Finance

Export Finance provided to the Clients (Exporters) can be broadly classified in to two categories, depending upon the stage of export activity at which the finance is availed. This represents Asset Side of the Bank which is funded based on the investments made by SBP on account of Export Refinance Scheme.

The two types of export financing are:

1. Pre shipment
2. Post Shipment

1. Pre Shipment

Financial assistance availed prior to the shipment of goods is termed as pre shipment finance.

2. Post Shipment

Financial assistance availed after shipment of goods is termed as post shipment finance.

As interest cannot be charged in any case, experts have proposed certain methods for financing exports

1. Pre shipment Financing

- Murabahah
- Istisna
- Musharakah

2. Post shipment Financing

- Wakalah / Qurdh-e-Hassana
- Salam
- Tawarruq

Pre-shipment Financing

1. Murabahah

Banks do Murabahah financing when exporter has to purchase the commodity or materials. Bank purchases the commodity on behalf of a client and resale it to the exporter on cost-plus-profit basis.

In other words rather than advancing money to a borrower, which is how the system would work in a conventional banking agreement, the bank will buy the goods from a third party and sell those goods on to the exporter for a pre-agreed price. This way the exporter will get the hold of the goods to be exported.

Steps Involved In The Murabahah Export Finance Scheme

If the client needs funds for the purchase of raw material, then the following process may be used:

- The bank upon receiving an application for export finance from an exporter will complete its credit evaluation and negotiation process with the exporter and will enter into a Murabahah Agreement with the exporter.
- Appropriate security may be obtained from the exporter under Murabahah Agreement.
- Exporter will select the goods for which it needs the Murabahah facility and request the bank for disbursement.
- The bank will appoint the Exports its agent to purchase the goods from the market and disburses funds to exporter for purchasing the asset on cost price and and upon receiving title and ownership of the goods the bank will sell the goods to the Exporter on Murabaha basis.
- After disbursement to exporter, the Bank will claim reimbursement from SBP.
- SBP will invest in Musharakah pool of the bank.
- Upon maturity of the period, Exporter will pay the Murabahah contract price to the bank.
- After completion of the transaction, on receipt of price from the client State Bank will redeem its share from the Musharakah pool equivalent to the financing amount while profit will be shared between the partners as per the actual performance of the pool as per the actual performance of the pool.

2. Istisna

Istisna is a sale transaction, where a commodity is transacted before it comes into existence. It is an order to a manufacturer to manufacture a specific commodity for the purchaser.

Bank requires Istisna, when exporter has to manufacture the goods for the importer. In Istisna, the exporter either uses his own material or if it is not available with him, obtains it to make the ordered goods. If the exporter has the raw material and seeks financing for the processing of a raw material, the bank may undertake to process the raw material on the basis of an

Istisna. If the exporter does not have a raw material and wants to purchase that too, the bank can provide him the raw materials also.

Steps Involved In The Istisna Export Finance Scheme

If the client needs funds for manufacturing the goods to be exported, then the following process may be used.

- Exporter will approach the bank to get financing for the manufacturing of specified goods. Exporter will inform the bank about the certain minimum sale price of the goods. The bank may get it verified from independent source. However, in case of a confirmed LC and/or contract sale price of the goods can be confirmed.

- The bank will give funds to the client under Istisna to manufacture and deliver the goods to the Bank.

- The bank needs to deduct its profit margin from the minimum export value of the goods.

- The bank can also ask for a security against Istisna facility.

- After disbursement of funds to the client, the Bank will claim reimbursement from SBP.

- SBP will invest in Musharakah pool of the bank.

- Once the goods are manufactured and are delivered to the bank they will be the property of the Bank.

- Under Istisna the customer is liable only to deliver goods to the Bank.

- For exporting the goods to the importer the Bank will appoint the exporter as its agent to export the goods on its behalf under a Wakalah agreement.

- Exporter will now export the goods, acting as the Bank's agent.

- The proceeds from Exports will be remitted to the Bank

- The Bank will deduct its cost of goods and profit (Istisna price) from the proceeds, and pay the balance to the client as service charges of Agency contract if it is stipulated in the agency contract.

- After completion of the transaction on receipt of Export proceeds State Bank will redeem its share from the Musharakah pool equivalent to the financing amount while profit will be shared between the partners as per the actual performance of the pool as per the actual performance of the pool.

3. Musharakah / Mudarabah

The most appropriate method for financing exports is Musharakah or Mudarabah.

Bank and exporter can make an agreement of Mudarabah provided that the exporter is not investing; otherwise Musharakah agreement can be made. Agreement in such case will be easy, as cost and expected profit is known.

The exporter will manufacture or purchase goods and the profit obtained by exporting it will be distributed between them according to the pre-defined ratio.

Steps Involved In The Musharakah / Mudarabah Export Finance Scheme

In this case following process may be followed.

- Exporter will inform the bank about the expected cost and expected profit from the transaction.
- The bank may verify the information provided by the exporter.
- After finalization of profit margin, exporter and the bank will decide the profit sharing ratio.
- The bank will disburse funds to the exporter.
- After disbursement to the client, the Bank will claim reimbursement from SBP.
- SBP will invest in Musharakah pool of the bank.
- Exporter will manufacture/procure and export the goods.
- After the remittance is received, exporter will pay the profit share of the bank.
- After completion of the transaction on receipt of Export proceeds State Bank will redeem its share from the Musharakah pool equivalent to the financing amount while profit will be shared between the partners as per the actual performance of the pool as per the actual performance of the pool.
- A condition can be added in the Musharakah contract, that if the goods are not manufactured and exported within a specified period Musharakah will stand terminated and the exporter will have to refund the principal. The exporter will be responsible for selecting credible buyer/importer, if it is proved that he was negligent in selecting the importer he will be liable to bear the loss of the bank caused by his negligence.
- In order to further secure himself from any negligence on the part of the exporter, the bank may put a condition that it will be the responsibility of the exporter to export the goods in full conformity with the conditions of the LC and/or contract.

- However, being a partner of the exporter, the bank will be liable to bear any loss, which may be caused due to any reason other than the negligence or misconduct of the exporter.

Post Shipment Financing

In conventional banking Post Shipment financing primarily involves discounting of export bills. The exporter in need of funds brings the bill to the bank for discounting to release the funds and get the liquidity.

However, the Islamic banks have number of ways in which it conducts the Post Shipment. Few common methods are:

- Wakalah Agreement
- Salam Agreement
- Tawarruq Agreement
- Murabaha Agreement

1. Wakalah Agreement

A relatively simpler mechanism can be adopted through the Wakalah-Interest Free loan arrangement, which is similar to the agency relationship. The procedure is discussed below:

- The bank will enter into a Wakalah Agreement with the exporter to collect receivables on behalf of exporter, with a particular commission based on the receivable amount. This fee would not vary with time of payment of receivable.

- It is essential that such fee must be charged from all the Export customer who have executed the Wakalah Agreement with the Bank, whether they avail this alternative to Bill discounting or not.

- The bank would advance an interest free loan to exporter equivalent to for less than the amount of receivable. The repayment period of the loan would be equivalent to the maturity period of the bill.

- The repayment of loan extended to exporter would be through setting off the amounts received from the importer.

- In case the payment is not received from the importer, exporter will repay the interest free loan obtained from the bank on the due date from its own sources.

2. Salam Agreement

Salam can be used to purchase foreign currency for the exporter. The process of the Salam transaction is as follows:

- Exporter brings the export documents to the bank.

- The Bank will enter into a Salam transaction with the exporter, whereby the Bank will buy Foreign Currency (FCY) from the customer (to be delivered on a specified future date) against PKR at the ready price of day to be paid full in advance. The rate must not be a discounted rate but the rate which is used at that time to buy FCY with immediate delivery.

- The Bank will make the payment in Local Currency (LCY) by converting face value in FCY of the documents at specified market rate.

- The FCY will be delivered by the customer at a specified future date and should not be contingent upon arrival of the LC proceeds.

- The Bank may ask the exporter to assign its receivable, under the LC, to the Bank.

- The Bank may also ask the exporter to furnish other securities to protect itself in case the exporter defaults.

- The bank will enter into a promise to sell FCY on a future date with a financial institution.

- The bank's profit will be based on the difference between the spot rate and the forward rate.

3. Tawarruq Agreement

In some cases Tawarruq arrangement can also be adopted for the Post shipment. Tawarruq means buying on credit and selling at spot to get the liquidity. The procedure as follows:

- Exporter will select a commodity, which is liquid in nature (For such as share of PTCL)

- The bank will purchase the commodity for the exporter and will sell it to the exporter on the basis of Murabahah/Muajjala (Credit sale at cost plus).

- The bank may take securities against Murabahah.

- After taking delivery of the commodity the exporter will sell the commodity in market on spot basis at current market prices.

- In this way exporter will obtain the required liquidity.

The Bank can be paid after receipt of payment from the importer.

4. Murabaha Agreement

The Bank may also offer alternative to Bill discounting based on the product of Murabaha as per the following method:

- Exporter has exported the goods and will receive the payment

in future but requires instant liquidity to procure raw material for fulfilling its upcoming Export Contracts.

- The Exporter will bring its Export Bill to the Bank and deposit it as a security.
- Against the Export bill, kept as security, the bank will extend a fresh Murabaha facility to the Exporter for less then the amount of the bill.
- The exporter will use the Murabaha funds to purchase goods from the market as an agent of the Bank.
- Upon receipt of the goods the bank will sell the goods to the customer on deferred payment basis. The Murabaha price will be equivalent to the face value of the bill and the deferred payment date may be the date of the maturity of Export proceeds.
- Upon receipt of the Export proceeds the Exporter will pay the Murabaha price to the Bank, however if the proceeds are not received on time then the Exporter will pay the Murabaha price on due date from its own resources.
- Difference between the cost price of the goods and the face value of the Export bill will be a valid profit for the bank from this transaction.

Interest Based Export Refinance Scheme

In order to promote exports of the country, the State Bank of Pakistan introduced in 1973, the Export Refinance Scheme, which provides finance to exporters at concessionary/subsidized mark up rates.

The Refinance Scheme is available in TWO parts:

- **Part I:** Under Part I, banks allow finance to exporters on a case by case basis, against export L/Cs, or specific export orders, both on pre shipment and post shipment basis, for a specified period of days. In the event of failure to exporter and/or submit documents within the stipulated time, a penal fine is charged.
- **Part II:** Under Part II of this scheme, exporters are eligible to obtain facilities on the basis of their past performance. This is simply a credit line available to clients on an ongoing basis for a particular time period.

Banks play a role of intermediary between the State Bank and the exporter. This refers to the Liability side of Balance Sheet for any Bank. According to this scheme bank does not have to finance exporters from their own money, instead the State Bank provides all the financing. The bank as an intermediary between the State Bank and the exporter receives service charges, which usually amounts to 1.5% of Refinance rates.

This is a conventional way of financing the exporter. Export Refinancing represents the liability side of the bank as the bank borrows money from the State Bank and provides lending to the exporter. Since all these activities of borrowing and lending are interest based, hence not allowed in Islam.

Islamic Alternative For The Liability Side

The Islamic alternatives to this scheme have been developed. According to Shariah, there are three ways to correct the liability side of the bank:

1. Musharakah
2. Mudarabah
3. Wakalat-ul-Istismar

Musharakah

Currently, State Bank of Pakistan provides this facility by entering into Musharakah agreements with Islamic Banks. The mechanism starts by identifying a pool of funds based on Shariah Compliant financing products. The SBP will invest in this fund out of which financing will be provided to the exporters. The compensation to the SBP will be provided from the income of the pool, which will be shared between SBP and Bank on a preagreed profit sharing ratio determined in the form of weightages. These weightages would be worked out in a manner that will give reasonable return to both SBP and the bank. In this manner, the Liability side can be managed.

For this purpose, the bank may include financial assets other than those assets, which are booked under export finance. To work out a reasonable and less volatile rate of return, the bank should have in the pool those assets which are relatively less risky and such as Murabahah, Ijarah, Salam and Istisna etc.

Chapter 26

Treasury Operations of Islamic Banks

Introduction

Financial markets of the world are now taking serious notice of the tremendous growth of Islamic banking in the international markets. This can be substantiated by the fact that instead of just having standalone Islamic funds and products, more and more, now banks and financial institutions are now planning to establish Islamic commercial banks to provide complete solutions to their Shariah sensitive customers.

Many, innovative financial structures have been developed to cater to different requirements of industrial and business customers. However as Islamic banking is still in its infancy emphasis has not been given on the development of inter bank transactions & treasury operations under Islamic modes.

Recently, due to the entry of a number of new Islamic banks and with the increase in balance sheets of the existing Islamic banks the need for development of Islamic treasury operations is being acutely felt. Central banks of Bahrain and Malaysia have done tremendous development in this regard. However, Islamic banks working in an environment where other Islamic banks either do not exist or their operations are very small face the real challenge, like Pakistan.

The purpose of this paper is to explore ways through which an Islamic bank can survive in such environment.

Need for Islamic Treasury Operation

Treasury operation of a conventional bank primarily involves following operations.

1. Short term acceptances
2. Short term investment & liquidity management
3. Bill purchase & discounting of receivables (Factoring & Forfeiting)
4. SPOT FX as well as, forward purchase and forward sale
5. Derivatives & options

The first two activities are usually practiced through the borrowing and lending on the basis of interest/returns/yields without, underlying asset structures in the conventional capital/money market. Involvement of Riba/interest in such transactions renders them Haram/prohibited according to Islamic Shariah. The last three (3rd, 4th and 5th) activities are also not allowed in Shariah because of involvement of Gharar as well as Riba.

However, one cannot disagree with the fact that all these activities are extremely important for smooth running of any bank and to facilitate trade and business. Therefore, there is a strong need to develop Islamic alternatives to such products.

Suggested Solutions

Islamic alternatives for each operation are as under:

Short term Acceptances

In case Islamic banks need funds they can access the short-term money market on either of the following basis:

1. Musharakah/Mudarabah (Profit sharing/Fund Management)
2. Tawarruq

Musharakah/Mudarabah contracts

In case Musharakah/Mudarabah are used for the purpose of accepting funds from the market following process may be used.

1. Islamic bank will create or securitize a pool of assets comprising Murabahah/Salam/Istisna and Ijarah preferably booked with high rated clients of the bank. The size of assets booked under Ijarah should be at least 51% of the total pool size. However, if Hanafi School of thought is adopted, trading will be allowed even if the non-liquid assets are less than 50% but the size of the non-liquid assets should not be negligible, which means it should at least be 10%.

2. Presence of the assets booked under above-mentioned modes (other than Musharakah and Mudarabah); make the volatility of profits accruing in the pool relatively lower.

3. Whenever the Islamic bank requires funds, they can contact any financial institution (FI), which will invest in these Assets on the basis of Musharakah/ Mudarabah.

4. A specific weightage/ratio would be assigned to the FI, keeping in view the agreed profit rate.

5. At the time of maturity of the investment, Islamic bank will calculate the return on the pool and share of the FI would be redeemed.

6. However It is essential to have an effective pool management system in the islamic bank that can ensure that sources and utilization of funds are known, balanced and verified at all time.

7. Proper segregation of assets among different pools and their profit sharing values (weightages) are assigned.
8. The FI pools are given a unique pool identification number at the time of pool creation.
9. This pin is used for asset allocation deal contimuation and other related accounting purpose.
10. Proper allocation of financing asset implies that related risk and reward (profit or return) assets are properly limited to a specific FI pool.

This arrangement can be employed if the volatility/ predictability of profits in the pool is reasonably acceptable, so that the return can be predicted easily.

However, it should be noted that the rules of Securitization in Islamic finance should be adopted completely, details of which may be explained separately.

Tawarruq

In some cases Tawarruq arrangement can also be adopted in the following manner:

1. Islamic bank will select a commodity/stocks, which is liquid in nature (such as metals sold in Commodity Exchange or shares of Microsoft Co) with the consent of the conventional bank.
2. Conventional bank will purchase the commodity from market and would sell the commodity to Islamic bank on Murabahah basis.
3. After taking delivery the Islamic bank will sell it to the market on spot basis. In this way Islamic bank will obtain the required liquidity.
4. Islamic bank will pay the price of the commodity to conventional bank on the due date.

Some institutions have developed products which are known as Commodity Murabahah and Reverse Murabahah on the above principles.

However, it should be noted that acceptability of Tawarruq transaction as a mode of financing is a controversial subject among the scholars. Some scholars allow this transaction to use as a mode of financing where each party transacts purchasing/selling the commodities directly without making the other as his agent to accomplish such transactions on his behalf. Secondly, this transaction should be used only where no other alternative except interest based financing is available. Therefore, specific approval from Shariah Advisor should be obtained for each transaction.

Placement and Liquidity Management

A major problem with Islamic banks is of Placements and Liquidity Management. Islamic banks generally have problems of surplus liquidity, rather than the lack of it.

These issues may be resolved in the following manner:

Musharakah/Mudarabah

Some conventional financial institutions such as leasing companies and investment banks book assets in both Islamic and conventional manner. Islamic bank should coordinate with these institutions to segregate the accounting processes of assets booked under Islamic structures. After the segregation process, a pool of these assets can be created.

Whenever Islamic banks have liquidity they can place their funds in these asset pools on the basis of Musharakah or Mudarabah in the same way as the bank borrows liquidity from conventional bank. The process would be reverse of the borrowing product. Therefore, Profit and Loss will be shared between the financial institution and the Islamic bank as per the principles of Musharakah and Mudarabah.

Islamic Bonds (Sukuks)

Dealing in conventional bonds is not permissible according to Shariah because of two aspects:

1. Firstly, they represent a portion of Debt payable by the issuer. Earning of any kind of profit falls under the category of Riba/Prohibited Returns.

2. Second aspect of Bonds pertains to the trading of Bonds. Shariah prohibits trading of debts (Bai Dayn) as it involves Gharar (Uncertainty), because if the debt is sold to a third person, and the borrower defaults in repayment of loan, there would not be recourse to the buyer of debt to receive the debt from the seller of debt. Therefore, it is uncertain (not confirmed) for the buyer of debt whether he would be able to get the amount receivable from the debtor. Therefore, Shariah only allows Hawalah (assignment of Debt), whereby the assignee of the debt has recourse to the assignor in case the debtor/borrower defaults in repayment. In short sale of debt is not allowed in Islam, therefore, sale of bond even at their face value is not allowed.

Therefore, it is very essential requirement to explore such alternatives of Bond, which can be traded freely in the secondary market in Shariah compliant way. These alternatives can be developed through securitization of assets. The security created through securitization of assets represents the proportionate ownership of the holder in illiquid or tradable assets. Trade of such securities is permissible, because it will be tantamount to the sale/ purchase of holder's proportionate share in the assets, which is allowed in Shariah.

For the purpose of securitization, pool of assets needs to be created and the operations of the pool would be as follows:

1. Portfolio may contain mixture of Ijarah and Murabahah assets. However the proportion of Ijarah assets should be more than 50% of the total worth of the pool. However as mentioned above, if Hanafi school of thought is adopted, trading will be allowed even if the non-liquid assets are less than 50% but the size of the non-liquid assets should not be negligible, which means at least 10%.

2. Every subscriber can be given a certificate, which represents his proportionate ownership in the assets of the portfolio.

3. Profit earned by the portfolio would be distributed among the subscriber according to their ratio of investment after deduction of management fee of the manager.

4. Loss, if any, would also be shared among the subscriber on pro rata basis.

5. Certificates can be bought and sold in the secondary market at any value.

The above structure can be used to issue long-term bonds by the governments and large corporations.

Government of Bahrain has successfully Issued Salam Sukuk as an Islamic alternative to Treasury Bills and Ijarah Sukuk as an alternative to Bonds. Details of which can be obtained from Bahrain Monetary Agency.

Issuance of Islamic Sukuk can also play a paramount role in liquidity management. A number of Islamic countries have issued Sukuks for this purpose including Bahrain, Malaysia, and Qatar. Government of Pakistan has also issued such certificates, initially in foreign currency and then in Pak Rupees. As discussed above the interesting thing about Sukuks is that they can be traded at any value/price in the secondary market just as any other treasury bill/bond. This feature of sukuks also helps in managing liquidity in the same manner as Treasury Bills/Bonds are used in the conventional market.

Reserve Requirement

The central bank should also grant special permissions for managing SLR and other statutory requirements through maintaining SLR without interest. Sukuks can also be used for this purpose. The Government of Pakistan issued sukuks are being given the SLR eligibility by the State Bank of Pakistan which is one of the major reasons for its success.

Forward Purchase and Sale of Currencies

Forward purchase and sale of currencies plays a very important role in facilitating imports and exports to hedge their proceeds. Islamic bank cannot enter into forward sale/purchase contracts. However in case of genuine needs of trade financing where importers or exporters want to

hedge/cover the risk of the fluctuation/volatility of the market, they can enter into promises to sell/buy as against sell/purchase of foreign currencies for future dates. The actual sale will take place on agreed date, but it should only be used for genuine needs of trade not for any speculative transactions. Therefore, Shariah scholars have issued guidelines for this purpose, which should be followed at the time of execution of these transactions.

Spot Sale and Purchase of currencies can be traded in the same manner as practiced conventionally. The term ready/spot refers to the delivery of both the currencies on the same day of execution of Sale Contract in context of Islamic transaction whereas under the conventional system the term spot refers to delivery of both the currencies after two days of execution of Sale Contract. Therefore all those transactions where delivery of either of the currency is deferred (irrespective of number of days) will not fall under spot sale but Islamic Alternative of Promise to Sell/Buy will be used in such transactions.

Bill Purchase

Bill purchase and its discounting is not allowed in Shariah as it involves Bai Al Dain (sale of debt) and Riba. However, assignment of debt (Hawalah Al Dain) is allowed.

Islamically lawful alternatives of bill purchase and discounting may be resorted to through the following modes:

1. Musharakah/Mudarabah
2. Wakalah & Hawalah
3. Bai Salam of Currencies
4. Tawarruq
5. Murabaha

The mode of Musharakah is discussed as follows whereas the remaining four methods have been discussed in Chapter number 28.

Musharakah/ Mudarabah

The bank will enter into a Musharakah arrangement with exporter. The bank will invest with exporter an amount equivalent to the existing receivables of the exporter (which are to be discounted) for manufacturing/supplying of goods to specifically identified customers of the exporter. Profit from these customers of exporter will be shared between the bank and the exporter as per agreed ratios. Profits can be shared at either of the following levels:

1. Operating Profit Level
2. Net Profit Level

For example the bank may agree with exporter that it will earn x% at operating profit level and so on. The important thing is the bank and the exporter need to agree that some percentage of profit earned from identified clients will be shared between the parties.

The bank can also hold existing receivables of customer as security against this Musharakah. They can be used if any negligence is proved on the part of the exporter.

Additionally, the bank may encash the bill on due date, and subsequently adjust them against actual profits and losses.

Call and Put Options and Derivatives

Option to Sell and Option to Purchase (Call and Put Options) are allowed in Shariah. However, fee charged on the options separately or transferring or selling these option which is known as Derivatives having Gharar are not permissible because these Options are right to sell/purchase of a subject matter given by the buyer/seller to seller/buyer and this right cannot be sold as per Shariah.

Similarly, short sale is not allowed in Shariah, as Islam prohibits selling thing, which is not owned and possessed (physically or constructively) by the seller. Therefore, long sell (after taking possession) is allowed and short sale is not allowed. However, it can be structured through promise to sell in case of any genuine need.

It should also be noted that to sell a thing before ownership and possession is allowed in Bai Salam and Bai Istisna transactions. Therefore, if required, transactions can be structured by using any of the above mode complying with all the conditions of Salam and Istisna.

Conclusion

Majority of the existing financial systems can be transformed into a Shariah compliant structure if they are beneficial to trade and real businesses. There is a strong need for a greater interaction of Shariah scholars and finance professionals for the development of smooth and practicable Shariah compliant systems and procedure. Universities can also play a very important role in creating such environment.

Chapter 27

Securitization

Securitization means issuing certificates of ownership against an investment pool or business enterprise. This chapter discusses the issues, problems and rules in issuing such certificates with respect to the "nature" of investment pool. Basic guidelines are also provided on the negotiability and sale of these certificates in the secondary markets.

Securitization of Musharakah

Musharakah is a mode of financing which can be securitized easily, especially, in the case of big projects where huge amounts are required which a limited number of people cannot afford to subscribe. Every subscriber can be given a Musharakah certificate, which represents his proportionate ownership in the assets of the Musharakah, and after the project is started by acquiring substantial non-liquid assets, these Musharakah certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. However, trading in these certificates is not allowed when all the assets of the Musharakah are still in liquid form (i.e. in the shape of cash or receivables or advances due from others).

For proper understanding of this point, it must be noted that subscribing to a Musharakah is different from advancing a loan. A bond issued to evidence a loan has nothing to do with the actual business undertaken with the borrowed money. The bond stands for a loan repayable to the holder in any case, and mostly with interest. The Musharakah certificate, on the contrary, represents the direct pro rata ownership of the holder in the assets of the project. If all the assets of the joint project are in liquid form, the certificate will represent a certain proportion of money owned by the project. For example, one hundred certificates, having a value of Rs. 1 million each, have been issued. It means that the total worth of the project is Rs. 100 million. If nothing has been purchased by this money, every certificate will represent Rs. 1 million. In this case, this certificate cannot be sold in the market except at par value, because if one certificate is sold for more than Rs. 1 million, it will mean that Rs. 1 million are being sold in exchange for more than Rs. 1 million, which is not allowed in Shariah, because where money is exchanged for money, both must be equal. Any excess at either side is Riba.

However, when the subscribed money is employed in purchasing non-liquid assets like land, building, machinery, raw material, furniture etc. the Musharakah certificates will represent the holders' proportionate ownership in these assets. Thus, in the above example, one certificate will stand for one hundredth share in these assets. In this case, it will be allowed by the Shariah to sell these certificates in the secondary market for any price agreed upon between the parties which may be more than the face value

of the certificate. Since the subject matter of the sale is a share in the tangible assets and not in money alone, therefore the certificate may be taken as any other commodity which can be sold with profit or at a loss.

In most cases, the assets of the project are a mixture of liquid and non-liquid assets. This comes to happen when the working partner has converted a part of the subscribed money into fixed assets or raw material, while rest of the money is still liquid. Or, the project, after converting all its money into non-liquid assets may have sold some of them and has acquired their sale proceeds in the form of money. In some cases the price of its sales may have become due on its customers but may have not yet been received. These receivable amounts, being a debt, are also treated as liquid money. The question arises about the rule of Shariah in a situation where the assets of the project are a mixture of liquid and non-liquid assets, whether the Musharakah certificates of such a project can be traded in? The opinions of the contemporary Muslim jurists are different on this point. According to the traditional Shafi school, this type of certificate cannot be sold. Their classic view is that whenever there is a combination of liquid and non-liquid assets, it cannot be sold unless the non-liquid part of the business is separated and sold independently.

The Hanafi school, however, is of the opinion that whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets in combination, in which case money will be taken as sold at an equal amount and the excess will be taken as the price of the non-liquid assets owned by the business.

Suppose, the Musharakah project contains 40% non-liquid assets i.e. machinery, fixtures etc. and 60% liquid assets, i.e. cash and receivables. Now, each Musharakah certificate having the face value of Rs. 100/- represents Rs. 60/- worth of liquid assets, and Rs. 40/- worth of non-liquid assets. This certificate may be sold at any price more than Rs. 60/- If it is sold at Rs. 110/- it will mean that Rs. 60 of the price are against Rs. 60/- contained in the certificate and Rs. 50/- is against the proportionate share in the non-liquid assets. But it will never be allowed to sell the certificate for a price of Rs. 60/- or less, because in the case of Rs. 60/- it will not set off the amount of Rs. 60, let alone the other assets.

According to the Hanafi view, no specific proportion of non-liquid assets in the whole is prescribed. Therefore, even if the non-liquid assets represent less than 50% in the whole, its trading according to the above formula is allowed.

However, most of the contemporary scholars, including those of Shafi school, have allowed trading in the units of the whole only if the non-liquid assets of the business are more than 50%.

Therefore, for a valid trading of the Musharakah certificates acceptable to all schools, it is necessary that the portfolio of Musharakah consists of

non-liquid assets valuing more than 50% of its total worth. However, if Hanafi view is adopted, trading will be allowed even if the non-liquid assets are less than 50% but the size of the non-liquid assets should not be negligible.

Securitization of Murabahah

Murabahah is a transaction, which cannot be securitized for creating a negotiable instrument to be sold and purchased in secondary market. The reason is obvious. If the purchaser/client in a Murabahah transaction signs a paper to evidence his indebtedness towards the seller/financier, the paper will represent a monetary debt receivable from him. In other words, it represents money payable by him. Therefore transfer of this paper to a third party will mean transfer of money. It has already been explained that where money is exchanged for money (in the same currency) the transfer must be at par value. It cannot be sold or purchased at a lower or a higher price. Therefore, the paper representing a monetary obligation arising out of a Murabahah transaction cannot create a negotiable instrument. If the paper is transferred, it must be at par value. However, if there is a mixed portfolio consisting of a number of transactions like Musharakah, leasing and Murabahah, then this portfolio may issue negotiable certificates subject to certain conditions.

Securitization of Ijarah

The arrangement of Ijarah has a good potential of securitization, which may help create a secondary market for the financiers on the basis of Ijarah. Since the lessor in Ijarah owns the leased assets, he can sell the asset, in whole or in part, to a third party who may purchase it and may replace the seller in the rights and obligations of the lessor with regard to the purchased part of the asset.

Therefore, if the lessor, after entering into Ijarah, wishes to recover his cost of purchase of the asset with a profit thereon, he can sell the leased asset wholly or partly either to one party or to a number of individuals. In the latter case, the purchase of a proportion of the asset by each individual may be evidenced by a certificate, which may be called 'Ijarah certificate'. This certificate will represent the holder's proportionate ownership in the leased asset and he will assume the rights and obligations of the owner/lessor to that extent. Since the assets is already leased to the lessee, lease will continue with the new owners, each one of the holders of this certificate will have the right to enjoy a part of the rent according to his proportion of ownership in the asset. Similarly he will also assume the obligations of the lessor to the extent of his ownership. Therefore, in the case of total destruction of the asset, he will suffer the loss to the extent of his ownership. These certificates, being an evidence of proportionate ownership in a tangible asset, can be negotiated and traded freely in the market and can serve as an instrument easily convertible into cash. Thus they may help in solving the problems of liquidity management faced by the Islamic banks and financial institutions.

It should be remembered, however, that the certificate must represent ownership of an undivided part of the asset with all its rights and obligations. Misunderstanding this basic concept, some quarters tried to issue

Ijarah certificates representing the holder's right to claim certain amount of the rental only without assigning to him any kind of ownership in the asset. It means that the holder of such a certificate has no relation with the leased asset at all. His only right is to share the rentals received from the lessee. This type of securitization is not allowed in Shariah. As explained earlier in this chapter, the rent after being due is a debt payable by the lessee. The debt or any security representing debt only is not a negotiable instrument in Shariah, because trading in such an instrument amounts to trade in money or in monetary obligation which is not allowed, except on the basis of equality, and if the equality of value is observed while trading in such instruments, the very purpose of securitization is defeated. Therefore, this type of Ijarah certificates cannot serve the purpose of creating a secondary market.

It is, therefore, necessary that the Ijarah certificates are designed to represent real ownership of the leased assets, and not only a right to receive rent.

Ijara Sukuks:

The basic feature of Ijarah sukuks is that they represent leased assets, i.e. without relating the sukuk holders to any common organization, company or institution. For instance, an aircraft leased to an airline can be represented in sukuks and owned by a thousand different sukukholders, each of them, individually and independently, presenting his sukuk(s) to the airline company and collecting the periodic rent without having to have any relation with other sukukholders. In other words, the Ijarah sukukholders are not owners of a share in a company that owns the leased airline, but simply a sharing owner, who only owns one thousandth or more of the plane itself.

In a second example let us assume that a group of investors bought an office building and divided up the ownership rights into many certificates of equal face value. The group may rent out the whole building for the next ten years, then sell these certificates to the public. A buyer of such a certificate is acquiring a share in the ownership of the office building, and an equal share in the net income from it for the term of the lease. Such certificates could be easily traded in the market. Moreover, their generation of steady rental income renders them even less risky than common stocks. This is because in common stocks both annual net income and capital gains or losses are variable, whereas in rent sharing certificates part of the future income stream is the contractually fixed rental payments.

Characteristics of Ijarah Sukuks

The characteristics of Ijarah sukuks stem from its nature and from the contractual relationship defined in the Ijarah contract governing it. These can summarize as follows:

1. Ijarah sukuks are securities representing the ownership of well defined existing and well-known assets that are tied up to a lease contract. This means that Ijarah sukuks can be traded in the market at a price determined by market forces. This includes inter alia, the general market conditions in the economy and in the financial market, the opportunity cost (current and expected return on new financing), prices of real investment assets and economic trends in the specific market related to securities and Ijarah sukuks, etc. The Ijarah sukuks are also subject to risks related to the ability and desirability of the lessee to pay the rental installments. Moreover, these are also subject to real market risks arising from potential changes in asset pricing and in maintenance and assurance costs.

2. Furthermore, the expected net return on some forms of Ijarah sukuks may not be completely fixed and determined in advance, since there might be some maintenance and insurance expenses that are not perfectly determined in advance. Consequently, in such cases, the amount of rent given in the contractual relationship represented by the sukuk represents a maximum return subject to deduction of this kind of maintenance and insurance expenditure.

3. Ijarah sukuks are completely negotiable and can be traded in the secondary markets. Subject to market conditions, these sukuks will offer a high degree of liquidity and therefore, have both the characteristics and necessary conditions for functioning as successful securities.

4. Ijarah sukukss will offer a high degree of flexibility from the point of view of their issuance management and marketability. The central government, municipalities, awqaf or any other asset users, private or public can issue the sukuks. Additionally, they can be issued by financial intermediaries or directly by users of the leased assets It should be noted that Ijarah sukukholders as owners bear full responsibility for what happens to their property. They are also required to maintain it in such a manner that the lessee may derive as much usufruct from it as possible.

Chapter 28

Islamic Investment Funds

The term 'Islamic Investment Fund' means a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn halal profit in strict conformity with the precepts of Islamic Shariah. The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rata profit actually earned by the Fund. These documents may be called 'certificates', 'units', 'shares' or may be given any other name, but their validity in terms of Shariah, will always be subject to two basic conditions:

1. Instead of a fixed return tied up with their face value, they must carry a pro-rata profit actually earned by the Fund. Therefore, neither the principal nor a rate of profit (tied up with the principal) can be guaranteed. The subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund. If the Fund earns huge profits, the return on their subscription will increase to that proportion. However, in case the Fund suffers loss, they will have to share it also, unless the loss is caused by the negligence or mismanagement, in which case the management, and not the Fund, will be liable to com pensate it.

2. The amounts so pooled together must be invested in a business acceptable to Shariah. It means that not only the channels of investment, but also the terms agreed with them must conform to the Islamic principles.

Keeping these basic requisites in view, the Islamic Investment Funds may accommodate a variety of modes of investment, which are discussed here briefly.

Equity Fund

In an equity or mutual fund (unit trust) the amounts are invested in the shares of joint stock companies. The profits are mainly derived through the capital gains by purchasing the shares and selling them when their prices are increased. Profits are also earned through dividends distributed by the relevant companies.

From this angle, dealing in equity shares can be acceptable in Shari'ah subject to the following conditions:

1. The main business of the company does not violate Shariah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance

companies, or the companies involved in some other business not approved by the Shariah, e.g. companies manufacturing, selling or offering liquor, pork, haram meat, or involved in gambling, night club activities, pornography, prostitution, or involved in the business of hire purchase or interest etc.

2. If the main business of these companies is halal, like automobiles, textile, etc. but they deposit their surplus amounts in an interestbearing account or borrow money on interest, the share holder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.

3. If some income from interest-bearing accounts or non-Halal activities is included in the income of the company, the proportion of such income should not exceed 5% of the total income. If it exceeds 5%, it is not permissible to invest in that company. However, if it does not exceed 5%, it must be given in charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity. Moreover, the company's total short term and long term investment in non-permissible business should not exceed 30% of the company's total market capitalization.

   It may be questioned "What is the basic rationale of this limitation of 5%?" Infact, there is no specific basis derived from the Holy Quran or Sunnah for the 5% rule of non halal (impermissible) income. However, this is only the collective outcome (consensus) or ijtihad of contemporary Shariah Scholars. To explain this consensus of their ruling, we shall have to go back to the origin or basis of company on Shariah perspective. As mentioned in the books and research papers of Islamic jurists, companies come under the ruling of Shirkatul Ainan. But if the rule of partnership is truly applied in a company, there is no possi bility for any kind of impermissible activity or income. Because every shareholder of a company is a sharik (partner) of the company, and every sharik, according to the Islamic jurisprudence, is an agent of the other partners in matters of joint business. Therefore, the mere purchase of a share of a company embodies an authorization from the shareholder to the company to carry on its business in whatever manner the management deems fit. If it is known to the shareholder that the company is involved in an un-Islamic transaction, and he continues to hold the shares of that company, it means that he has authorized the management to proceed with that un-Islamic transac tion. In this case, he will not only be responsible for giving his consent to an un-Islamic transaction, but that transaction will also be rightfully attributed to himself, because the management of the company is working under his tacit authorization.

   However, a large number of Shariah Scholars say that Joint Stock

Company is basically different from a simple partnership. In partnership, all the policy decisions are taken through the consensus of all partners, and each one of them has a veto power with regard to the policy of the business. Therefore, all the actions of a partnership are rightfully attributed to each partner. Conversely, the majority takes the policy decisions in a joint stock company. Being composed of a large number of shareholders, a company cannot give a veto power to each shareholder. The opinions of individual shareholders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every shareholder in his individual capacity. If a shareholder raises an objection against a particular trans action in an Annual General Meeting, but his objection is overruled by the majority, it will not be fair to conclude that he has given his consent to that transaction in his individual capacity, especially when he intends to refrain from the income resulting from that transaction.

Therefore, if a company is engaged in a halal (permissible) business, but also keeps its surplus money in an interest-bearing account, wherefrom a small incidental income of interest is received, it does not render all the business of the company unlawful. Now, if a person acquires the shares of such a company with clear intention that he will oppose this incidental transaction also, and will not use that proportion of the dividend for his own benefit, then it cannot be said that he has approved the transaction of interest and hence that transaction should not be attributed to him.

In short, the matter of traditional partnership is different from the partnership of company in this aspect. Therefore if a very small amount of income is earned through these means despite of his disapproval, then his trade in shares would be permissible with the condition that, he shall have to purify that proportion of income by giving it to charity. Now a question could be raised as to what extent or what limit that income would be forgone. Definitely, this matter could not be left on decisions or opinions of lay men, therefore, it was resolved through the consensus of proficient Shariah Scholars that the limit of impermissible income should not exceed 5% of the total income.

4. The leverage or debt to equity ratio of the company should not exceed 30%. To explain the rationale behind this condition, it should be kept in mind that, such companies sometimes borrow money from financial institutions that are mostly based on interest. Here again the aforementioned principle applies i.e. if a shareholder is not personally agreeable to such borrowings, but has been overruled by the majority, these borrowing transactions cannot be attributed to him.

   Moreover, even though according to the principles of Islamic jurisprudence borrowing on interest is a grave and sinful act, for which the borrower is responsible in the Hereafter; but, this sinful act does not render the whole business of the borrower as Haram (impermissible).

It is explained in the conventional books of Islamic jurisprudence that the contract of loan is among those, that are called "Uqood Ghair Muawadha" (Non compensatory contracts), therefore, no void condition such as condition of interest can be stipulated. However, if such a condition has been stipulated, the condition itself is void, but it will not invalidate the contract. Since, the contract remains valid despite of void condition, the borrowed amount would be permissible to use and it would be recognized as owned by the borrower. Hence, anything purchased in exchange for that money would not be unlawful. However, the responsibility of committing the sinful act of borrowing on interest rests on the person who willfully indulges in such a transaction but this does not render his entire business as unlawful. But it should also be remembered that the extent of investment in shares of companies, that involve borrowing should be limited. Can this limit be the same as the 5% limit that is applied to interest income? No, because in this case this activity does not affect the income of the company, it is less severe than interest based income, therefore, Shariah scholars and Islamic jurists extended the limit (from 5% which is limit of interest/impermissible income) to 30%. The basis of 30% is that the 30% is less than one third (1/3rd) of the total asset of the company and one third has been considered abundant by the following Hadith of the Holy prophetﷺ "والثلث كثير"One third is big or abundant" (Tirmizy). Hence whatever is less than one third, would be insignificant. Therefore to avoid the majority or abundance specified in the hadith, such limit is fixed at less than one third of the total asset of the company.

5. The shares of a company are negotiable only if the company owns some illiquid assets. If all the assets of a company are in liquid form, i.e. in the form of money they cannot be purchased or sold except at par value, because in this case the share represents money only and the money cannot be traded in except at par.

   What should be the exact proportion of illiquid assets of a company for warranting the negotiability of its shares? The contemporary scholars have different views about this question. Some scholars are of the view that the ratio of illiquid assets must be 51% in the least. They argue that if such assets are less than 50%, then most of the assets are in liquid form, and therefore, all its assets should be treated as liquid on the basis of the juristic principle:

"للأكثر حكم الكل "

''The majority deserves to be treated as the whole thing''

Some other scholars are of the view that even if the illiquid asset of a company is 33%, its shares can be treated as negotiable. The basis of this view is a well-known Hadith that means " والثلث كثير""One third is big or abundant" (Tirmizy).

They say that according to the Hadith one-third illiquid assets will be considered as sufficient or abundant for this purpose. The third view (of the scholars of the sub continent of Pakistan and India) is based on the Hanafi jurisprudence. The principle of the Hanafi School is that whenever an asset is a combination of liquid and illiquid assets, it can be negotiable irrespective of the proportion of its liquid part. However, this principle is subject to two conditions:

1. The illiquid part of the combination must not be in insignificant quantity. It means that it should be in a considerable proportion.

2. The price of the combination should be more than the value of the liquid amount contained therein. For example, if a share of 100 dollars represents 75 dollars, plus some fixed assets, the price of the share must be more than 75 dollars. In this case, if the price of the share is fixed at 105, it will mean that 75 dollars are in exchange of 75 dollars owned by the share and the balance of 30 dollars is in exchange of the fixed assets. Conversely, if the price of that share is fixed at 70 dollars, it will not be allowed, because the 75 dollars owned by the share are in this case against an amount which is less than 75. This kind of exchange falls within the definition of 'riba' and is not allowed. Similarly, if the price of the share, in the above example, is fixed at 75 dollars, it will not be permissible, because if we presume that 75 dollars of the price are against 75 dollars owned by the share, no part of the price can be attributed to the fixed assets owned by the share. Therefore, some part of the price (75 dollars) must be presumed to be in exchange of the fixed assets of the share. In this case, the remaining amount will not be adequate for being the price of 75 dollars. For this reason the transaction will not be valid. However, in practical terms, this is merely a theoretical possibility, because it is difficult to imagine a situation where the price of a share goes lower than its liquid assets.

Among the three different views mentioned above, the most conservative view is the first one. Therefore, nowadays that has been adopted by the majority of Shariah boards of Islamic mutual funds or in screening of the Islamic stocks methodology.

Subject to aforesaid conditions, the purchase and sale of shares is permissible in Shariah. An Islamic Equity Fund can be established on this basis. The subscribers to the Fund will be treated in shari'ah as partners inter se. All the subscription amounts will form a joint pool and will be invested in purchasing the shares of different companies. The profits can accrue either through dividends distributed by the relevant companies or through the appreciation in the prices of the shares. In the first case i.e. where the profits are earned through dividends, a certain proportion of the dividend, which corresponds to the proportion of interest earned by the company, must be given in charity. The contemporary Islamic Funds have termed this process as 'purification'.

Some scholars are of the view that even in the case of capital gains, the process of 'purification' is necessary, because the market price of the share may reflect an element of interest included in the assets of the company. The method of purification adopted by Dow Jones Islamic Market Index and Islmiqstocks.com are in favor of this view.

As we have discussed above for the negotiability of the share, it is essential for the share or securities that they represent more than 55% illiquid assets. If a mutual fund has 10% cash and 90% shares, we shall have to see how much of these shares represent fixed assets. Fixed assets include land, equipment, machinery and leased assets. If these shares represent more than 55% of fixed or illiquid assets, such shares or Musharkah certificates of mutual fund can be negotiated at other than par value as well.

Sale of option short sale, future sale and forward sale where some principles of Shariah are lacking are not permissible.

Management of the fund

The management of the fund may be carried out in two alternative ways. The managers of the Fund may act as mudaribs for the subscribers. In this case, a certain percentage of the annual profit accrued to the Fund may be determined as the reward of the management, meaning thereby that the management will get its share only if the fund has earned some profit. If there is no profit in the fund, the management will deserve nothing. The share of the management will increase with the increase of profits.

The second option for the management is to act as an agent for the subscribers. In this case, the management may be given a pre-agreed fee for its services. This fee may be fixed in lump sum or as a monthly or annual remuneration. According to the contemporary Shariah scholars, the fee can also be based on a percentage of the net asset value of the fund. For example, it may be agreed that the management will get 2% or 3% of the net asset value of the fund at the end of every financial year.

However, it is necessary in Shariah to determine any one of the aforesaid methods before the launch of the fund. The practical way for this would be to disclose in the prospectus of the fund the basis on which the fees of the management will be paid. It is generally presumed that whoever subscribes to the fund agrees with the terms mentioned in the prospectus. Therefore, the manner of paying the management will be taken as agreed upon by all the subscribers.

Ijarah Fund

Another type of Islamic Fund may be an Ijarah fund. Ijarah means leasing the detailed rules of which have already been discussed in chapter 23 this book. In this fund the subscription amounts are used to purchase assets like real estate, motor vehicles or other equipment for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users. These rentals are the source of income for the fund, which is distributed pro rata to the subscribers. Each subscriber is given a certificate to evidence his proportion

ate ownership in the leased assets and to ensure his entitlement to the pro rata share in the income. These certificates may preferably be called 'sukuk' - a term recognized in the traditional Islamic jurisprudence. Since these sukuk represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these sukuk replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. The price of these sukuk certificates will be determined on the basis of market forces, and are normally based on their profitability.

However, it should be kept in mind that the contracts of leasing must conform to the principles of Shariah which substantially differ from the terms and conditions used in the agreements of conventional financial leases. The points of difference are explained in detail in the third chapter of this book. However, some basic principles are summarized here:

1. The leased assets must have some usufruct, and the rental must be charged only from that point of time when the usufruct is handed over to the lessee.

2. The leased assets must be of a nature that their halal (permissible) use is possible.

3. The lessor must undertake all the responsibilities consequent to the ownership of the assets.

4. The rental must be fixed and known to the parties right at the beginning of the contract.

In this type of the fund, the management should act as an agent of the subscribers and should be paid a fee for its services. The management fee may be a fixed amount or a proportion of the rentals received. Most of the Muslim jurists are of the view that such a fund cannot be created on the basis of Mudaraba, because Mudaraba, according to them, is restricted to the sale of commodities and does not extend to the business of services and leases. However, in the Hanbali School, Mudaraba can be effected in services and leases also. This view has been preferred by a number of contemporary scholars.

Another possible type of Islamic Funds may be a commodity fund. In the fund of this type the subscription amounts are used in purchasing different commodities for the purpose of their resale. The profits generated by the sales are the income of the fund, which is distributed pro rata among the subscribers.

In order to make this fund acceptable to Shariah, it is necessary that all the rules governing the transactions of sale are fully complied with. For example:

1. The seller must own the commodity at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in Shariah.

2. Forward sales are not allowed except in the case of Salam and Istisna (For their full details, see chapters 17 & 20 respectively).

3. The commodities must be halal. Therefore, it is not allowed to deal in wines, pork or other prohibited materials.

4. The seller must have physical or constructive possession over the commodity he wants to sell. (Constructive possession includes any act by which the risk of the commodity is passed on to the purchaser).

5. The price of the commodity must be fixed and known to the parties. Any price, which is uncertain or is tied up with an uncertain event, renders the sale invalid.

In view of the above and similar other conditions, more fully described in the previous chapters of this book, it may easily be understood that the transactions prevalent in the contemporary commodity markets, specially in the futures commodity markets do not comply with these conditions. Therefore, an Islamic Commodity Fund cannot enter into such transactions. However, if there are genuine commodity transactions observing all the requirements of Shariah, including the above conditions, a commodity fund may well be established. The units of such a fund can also be traded in with the condition that the portfolio owns some commodities at all times.

Murabahah Fund

'Murabahah' is a specific kind of sale where the commodities are sold on a cost-plus basis. The contemporary Islamic banks and financial institutions as a mode of financing have adopted this kind of sale. They purchase the commodity for the benefit of their clients, then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units cannot be negotiable in a secondary market. The reason is that in the case of murabahah, as undertaken by the present financial institutions, the commodities are sold to the clients immediately after their purchase from the original supplier, while the price being on deferred payment basis becomes a debt payable by the client. Therefore, the portfolio of murabahah does not own any tangible assets. It comprises either cash or the receivable debts, Therefore, the units of the fund represent either the money or the receivable debts, and both these things are not negotiable, as explained earlier. If they are exchanged for money, it must be at par value.

Bai-Al-Dain

Here comes the question whether or not Bai-al-dain is allowed in Shariah. Dain means 'debt' and Bai means sale. Bai-al-dain, therefore, connotes the sale of debt. If a person has a debt receivable from a person and he wants to sell it at a discount, as normally happens in the bills of exchange, it is

termed in Shariah as Bai-al-dain. The traditional Muslim jurists (fuqah) are unanimous on the point that Bai-al-dain with discount is not allowed in Shariah. The overwhelming majority of the contemporary Muslim scholars are of the same view. However, some scholars of Malaysia have allowed this kind of sale. They normally refer to the ruling of Shafai school wherein it is held that the sale of debt is allowed, but they did not pay attention to the fact that the Shafai jurists have allowed it only in a case where a debt is sold at its par value.

In fact, the prohibition of Bai-al-dain is a logical consequence of the prohibition of 'riba' or interest. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to 'riba' and can never be allowed in Shariah.

Some scholars argue that the permissibility of Bai-al-dain is restricted to a case where the debt is created through the sale of a commodity. In this case, they say, the debt represents the sold commodity and its sale may be taken as the sale of a commodity. The argument, however, is devoid of force. For, once the commodity is sold, its ownership is passed on to the purchaser and it is no longer owned by the seller. What the seller owns is nothing other than money. Therefore if he sells the debt, it is no more than the sale of money and it cannot be termed by any stretch of imagination as the sale of the commodity.

That is why the overwhelming majority of the contemporary scholars have not accepted this view. The Islamic Fiqh Academy of Jeddah, which is the largest representative body of the Shariah scholars and has the representation of all the Muslim countries, including Malaysia, has approved the prohibition of Bai-al-dain unanimously without a single dissent.

Mixed Fund

Another type of Islamic Fund may be of a nature where the subscription amounts are employed in different types of investments, like equities, leasing, commodities etc. This may be called a Mixed Islamic Fund. In this case if the tangible assets of the Fund are more than 51% while the liquidity and debts are less than 50% the units of the fund may be negotiable. However, if the proportion of liquidity and debts exceeds 50%, its units cannot be traded according to the majority of the contemporary scholars. In this case the Fund must be a closed-end Fund.

Capital Protected Fund

A capital protected fund is a type of fund that guarantees the safety and protection of the capital invested along with stable returns on such investments. A Shariah compliant capital protected fund may be formed and operated in teh following manner:

1. Major portion of the capital say 95% is invested in a less riskier transaction, for instance Murabaha, on such a profit rate to make it 100% of the initial capital amount.

2. The remainaing 5% of the captal is invested in a high risk and high return investments such as that of shares.

The concept of guaranteening the protection of capital is not in exact accordance with the rulings of Shariah and so a Shariah Compliant capital protected fund may give a resonable and not absolute assurance of the protection of the capital.

Chapter 29

The Principle Of Limited Liability

The concept of 'limited liability' has now become an inseparable ingredient of the large-scale enterprises of trade and industry throughout the modern world, including the Muslim countries. The present chapter aims to explain this concept and evaluate it from the Shariah point of view in order to know whether or not this principle is acceptable in a pure Islamic economy.

The limited liability in the modern economic and legal terminology is a condition under which a partner or a shareholder of a business secures himself from bearing a loss greater than the amount he has invested in a company or partnership with limited liability. If the business incurs a loss, the maximum a shareholder can suffer is that he may lose his entire original investment. But the loss cannot extend to his personal assets, and if the assets of the company are not sufficient to discharge all its liabilities, the creditors cannot claim the remaining part of their receivables from the personal assets of the shareholders.

Although, the concept of 'limited liability' was, in some countries applied to the partnership also, yet, it was most commonly applied to the companies and corporate bodies. Rather, it will be truer, perhaps, to say that the concept of 'limited liability' originally emerged with the emergence of the corporate bodies and joint stock companies. The basic purpose of the introduction of this principle was to attract the maximum number of investors to the large-scale joint ventures and to assure them that their personal fortunes will not be at stake if they wish to invest their savings in such a joint enterprise. In the practice of modern trade, the concept proved itself to be a vital force to mobilize large amounts of capital from a wide range of investors.

No doubt, the concept of 'limited liability' is beneficial to the shareholders of a company. But, at the same time, it may be injurious to its creditors. If the liabilities of a limited company exceed its assets, the company becomes insolvent and is consequently liquidated, the creditors may lose a considerable amount of their claims, because they can only receive the liquidated value of the assets of the company, and have no recourse to its shareholders for the rest of their claims. Even the directors of the company who may be responsible for such an unfortunate situation cannot be held responsible for satisfying the claims of the creditors. It is this aspect of the concept of 'limited liability' which requires consideration and research from the Shariah viewpoint.

Although, the concept of 'limited liability' in the context of the modern

commercial practice is a new concept and finds no express mention as such in the original sources of Islamic Fiqh, yet the Shariah viewpoint about it can be sought in the principles laid down by the Holy Quran, the Sunnah of the Holy Prophet ﷺ and the Islamic jurisprudence. This exercise requires some sort of ijtihad carried out by the persons qualified for it. This ijtihad should preferably be undertaken by the Shariah scholars at a collective level, yet, as a pre-requisite, there should be some individual effort, which may serve as a basis for the collective exercise.

As a humble student of Shariah, this author have been considering the issue since long, and what is going to be presented in this article should not be treated as a final verdict on this subject, nor an absolute opinion on the point. It is the outcome of initial thinking on the subject, and the purpose of this article is to provide a foundation for further research.

The question of 'limited liability' it can be said, is closely related to the concept of juridical personality of the modern corporate bodies. According to this concept, a joint-stock company in itself enjoys the status of a separate entity as distinguished from the individual entities of its shareholders. The separate entity as a fictive person has legal personality and may thus sue and be sued, may make contracts, may hold property in its name, and has the legal status of a natural person in all its transactions entered into in the capacity of a juridical person.

The basic question, it is believed, is whether the concept of a 'juridical person' is acceptable in Shariah or not. Once the concept of 'juridical person' is accepted and it is admitted that, despite its fictive nature, a juridical person can be treated as a natural person in respect of the legal consequences of the transactions made in its name, we will have to accept the concept of 'limited liability' which will follow as a logical result of the former concept. The reason is obvious. If a real person i.e. a human being dies insolvent, his creditors have no claim except to the extent of the assets he has left behind. If his liabilities exceed his assets, the creditors will certainly suffer, no remedy being left for them after the death of the indebted person.

Now, if we accept that a company, in its capacity of a juridical person, has the rights and obligations similar to those of a natural person, the same principle will apply to an insolvent company. A company, after becoming insolvent, is bound to be liquidated: and the liquidation of a company corresponds to the death of a person, because a company after its liquidation cannot exist any more. If the creditors of a real person can suffer, when he dies insolvent, the creditors of a juridical person may suffer too, when its legal life comes to an end by its liquidation.

Therefore, the basic question is whether or not the concept of 'juridical person' is acceptable to Shariah.

Although, the idea of a juridical person, as envisaged by the modern economic and legal systems has not been dealt with in the Islamic Fiqh, yet there are certain precedents wherefrom the basic concept of a juridical person may be derived by inference.

1. Waqf

The first precedent is that of a Waqf. A Waqf is a legal and religious institution wherein a person dedicates some of his properties for a religious or a charitable purpose. The properties, after being declared as Waqf, no longer remain in the ownership of the donor. The beneficiaries of a Waqf can benefit from the corpus or the proceeds of the dedicated property, but they are not its owners. Its ownership vests in Allah Almighty alone.

It seems that the Muslim jurists have treated the Waqf as a separate legal entity and have ascribed to it some characteristics similar to those of a natural person. This will be clear from two rulings given by the fuqaha (Muslim jurists) in respect of Waqf.

Firstly, if a property is purchased with the income of a Waqf, the purchased property cannot become a part of the Waqf automatically. Rather, the jurists say, the property so purchased shall be treated, as a property owned by the Waqf. It clearly means that a Waqf, like a natural person, can own a property.

Secondly, the jurists have clearly mentioned that the money given to a mosque as donation does not form part of the Waqf, but it passes to the ownership of the mosque.

Here again the mosque is accepted to be an owner of money. Some jurists of the Maliki School have expressly mentioned this principle also. They have stated that a mosque is capable of being the owner of something. This capability of the mosque, according to them, is constructive, while the capability enjoyed by a human being is physical.

Another renowned Maliki jurist, namely, Ahmad Al-Dardir رح, validates a bequest made in favor of a mosque, and gives the reason that a mosque can own properties. Not only this, he extends the principle to an inn and a bridge also, provided that they are Waqf.

It is clear from these examples that the Muslim jurists have accepted that a Waqf can own properties. Obviously, a Waqf is not a human being, yet they have treated it as a human being in the matter of ownership. Once its ownership is established, it will logically follow that it can sell and purchase, may become a debtor and a creditor and can sue and be sued, and thus all the characteristics of a 'juridical person' can be attributed to it.

2. Baitul-Mal

Another example of 'juridical person' found in our classic literature of Fiqh is that of the Baitul-mal (the exchequer of an Islamic state). Being public property, all the citizens of an Islamic state have some beneficial right over the Baitul-mal, yet, nobody can claim to be its owner. Still, the Baitul-mal has some rights and obligations. Imam Al-Sarakhsi, the well-known Hanafi jurist, says in his work "Al-Mabsut": "The Baitul-mal has some rights and obligations, which may possibly be undetermined."

At another place the same author says: "If the head of an Islamic state needs money to give salaries to his army, but he finds no money in the Kharaj department of the Baitul-mal (wherefrom the salaries are generally given) he can give salaries from the sadaqah (Zakah) department, but the amount so taken from the sadaqah department shall be deemed to be a debt on the Kharaj department".

It follows from this that not only the Baitul-mal, but also the different departments therein can borrow and advance loans to each other. The liability of these loans does not lie on the head of state, but on the concerned department of Baitul-mal. It means that each department of Baitul-mal is a separate entity and in that capacity it can advance and borrow money, may be treated a debtor or a creditor, and thus can sue and be sued in the same manner as a juridical person does. It means that the Fuqaha of Islam have accepted the concept of juridical person in respect of Baitul-mal.

3. Joint Stock

Another example very much close to the concept of 'juridical person' in a joint stock company is found in the Fiqh of Imam Shafai رحمة الله عليه. According to a settled principle of Shafai School, if more than one person run their business in partner-ship, where their assets are mixed with each other, the Zakah will be levied on each of them individually, but it will be payable on their joint-stock as a whole, so much so that even if one of them does not own the amount of the nisab, but the combined value of the total assets exceeds the prescribed limit of the nisab, zakah will be payable on the whole joint-stock including the share of the former, and thus the person whose share is less than the nisab shall also contribute to the levy in proportion to his ownership in the total assets, whereas he was not subject to the levy of zakah, had it been levied on each person in his individual capacity.

The same principle, which is called the principle of 'Khultah-al-Shuyu' is more forcefully applied to the levy of Zakah on the livestock. Consequently, a person sometimes has to pay more Zakah than he was liable to in his individual capacity, and sometimes he has to pay less than that. That is why the Holy Prophet ﷺ has said: 'The separate assets should not be joined together nor the joint assets should be separated in order to reduce

the amount of Zakah levied on them'.

This principle of 'Khultah-al-Shuyu' which is also accepted to some extent by the Maliki and Hanbali schools with some variance in details, has a basic concept of a juridical person underlying it. It is not the individual, according to this principle, who is liable to Zakah. It is the 'joint-stock' that has been made subject to the levy. It means that the 'joint-stock' has been treated a separate entity, and the obligation of Zakah has been diverted towards this entity which is very close to the concept of a 'juridical person', though it is not exactly the same.

4. Inheritance under debt

The fourth example is the property left by a deceased person whose liabilities exceed the value of all the property left by him. For the purpose of brevity we can refer to it as 'inheritance under debt'.

According to the jurists, this property is neither owned by the deceased, because he is no more alive, nor is it owned by his heirs, for the debts on the deceased have a preferential right over the property as compared to the rights of the heirs. It is not even owned by the creditors, because the settlement has not yet taken place. They have their claims over it, but it is not their property unless it is actually divided between them. Being property of nobody, it has its own existence and it can be termed a legal entity. The heirs of the deceased or his nominated executor will look after the property as managers, but they are not the owners. If the process of the settlement of debt requires some expenses, the same will be met by the property itself.

Looked at from this angle, this 'inheritance under debt' has its own entity which may sell and purchase, becomes debtor and creditor, and has the characteristics very much similar to those of a 'juridical person.' Not only this, the liability of this 'juridical person' is certainly limited to its existing assets. If the assets do not suffice to settle all the debts, there is no remedy left with its creditors to sue anybody, including the heirs of the deceased, for the rest of their claims.

These are some instances where the Muslim jurists have affirmed a legal entity, similar to that of a juridical person. These examples would show that the concept of 'juridical person' is not totally foreign to the Islamic jurisprudence, and if the juridical entity of a joint-stock company is accepted on the basis of these precedents, no serious objection is likely to be raised against it.

As mentioned earlier, the question of limited liability of a company is closely related to the concept of a 'juridical person'. If a 'juridical person' can be treated a natural person in its rights and obligations, then, every person is liable only to the limit of the assets he owns, and in case he dies insolvent no other person can bear the burden of his remaining liabilities, how

ever closely related to him he may be. On this analogy the limited liability of a joint-stock company may be justified.

The limited liability of the master of a slave

Here I would like to cite another example with advantage, which is the closest example to the limited liability of a joint-stock company. The example relates to a period of our past history when slavery was in vogue, and the slaves were treated as the property of their masters and were freely traded in. Although, the institution of slavery with reference to our age is something past and closed, yet the legal principles laid down by our jurists while dealing with various questions pertaining to the trade of slaves are still beneficial to a student of Islamic jurisprudence, and we can avail of those principles while seeking solutions to our modern problems and in this respect, it is believed that this example is the most relevant to the question at issue. The slaves in those days were of two kinds. The first kind was of those who were not permitted by their masters to enter into any commercial transaction. A slave of this kind was called 'Qinn'. But there was another kind of slaves who were allowed by their masters to trade. A slave of this kind was called Abde Mazoon in Arabic. The initial capital for the purpose of trade was given to such a slave by his master, but he was free to enter into all the commercial transactions. The capital invested by him totally belonged to his master. The income would also vest in him, and whatever the slave earned would go to the master as his exclusive property. If in the course of trade, the slave incurred debts, the same would be set off by the cash and the stock present in the hands of the slave. But if the amount of such cash and stock would not be sufficient to set off the debts, the creditors had a right to sell the slave and settle their claims out of his price. However, if their claims would not be satisfied even after selling the slave, and the slave would die in that state of indebtedness, the creditors could not approach his master for the rest of their claims.

Here, the master was actually the owner of the whole business, the slave being merely an intermediary tool to carry out the business transactions. The slave owned nothing from the business. Still, the liability of the master was limited to the capital he invested including the value of the slave. After the death of the slave, the creditors could not have a claim over the personal assets of the master.

This is the nearest example found in the Islamic Fiqh, which is very much similar to the limited liability of the share holders of a company, which can be justified on the same analogy.

On the basis of these five precedents, it seems that the concepts of a juridical person and that of limited liability do not contravene any injunction of Islam. But at the same time, it should be emphasized, that the concept of 'limited liability' should not be allowed to work for cheating people and escaping the natural liabilities consequent to a profitable trade. So, the concept could be restricted, to the public companies only who issue their shares to the general public and the number of whose shareholders is so large that each one of them cannot be held responsible for the day-to-day

affairs of the business and for the debts exceeding the assets.

As for the private companies or the partnerships, the concept of limited liability should not be applied to them, because, practically, each one of their shareholders and partners can easily acquire knowledge of the day-to-day affairs of the business and should be held responsible for all its liabilities.

There may be an exception for the sleeping partners or the shareholders of a private company who do not take part in the business practically and their liability may be limited as per agreement between the partners.

If the sleeping partners have a limited liability under this agreement, it means, in terms of Islamic jurisprudence, that they have not allowed the working partners to incur debts exceeding the value of the assets of the business. In this case, if the debts of the business increase from the specified limit, it will be the sole responsibility of the working partners who have exceeded the limit.

The upshot of the foregoing discussion is that the concept of limited liability can be justified, from the Shariah view point, in the public joint-stock companies and those corporate bodies only who issues their shares to general public. The concept may also be applied to the sleeping partners of a firm and to the shareholders of a private company who take no active part in the business management. But the liability of the active partners in a partnership and active shareholders of a private company should always be unlimited.

At the end, we should again recall what has been pointed out at the outset. The issue of limited liability, being a modern issue, which requires a collective effort to find out its solution in the light of Shariah, the above discussion should not be deemed to be a final verdict on the subject. This is only the outcome of an initial thinking, which always remains subject to further study and research.

Chapter 30

Takaful: The Islamic Insurance

Conventional Insurance

In conventional term, Insurance is a way to provide security/and compensation to what is valuable in the event of its loss, damage or destruction based on the principle of risk taking and speculation.
According to Shariah, there are two aspects of Conventional Insurance, namely:

- Conceptual aspect
- Practical aspect

So far as the concept of insurance is concerned, it is to cover the risk of loss, or "fortunate many helping the unfortunate few".

This concept is not only recognized, but also encouraged and rewarded by Islam.

"وتعاونوا علي البرّ والتقوي ولا تعاونوا علي الاثم والعدوان" (سورة المائدة, أية 2)

"Help one another in righteousness and piety, but do not help one another in sin and transgression". (Al Quran 5: 2)

The principles of Muwalat, Maaqil, Kafalah (Guarantee), Dhaman (indemnity) and the establishment of Islamic welfare state by the Holy Prophet ﷺ Waqf and Tabarru support this concept.

The practical aspect of Insurance, however, is forbidden due to the following elements:

- Qimar or Mysir (Gambling)
- Riba (Interest)

Since both are clearly prohibited by Quran and Hadith, they cannot be permitted on the pretext of the conceptual aspect i.e. helping victims of accidents and other losses; just as major sins like theft, robbery, gambling, dealing in riba etc. cannot be permitted with the pretext of helping the poor and needy from their proceeds.

Mysir

There are two basic elements that invalidates Mysir:
- Khatar (خطر)
- Gharar (غرر)

Khatar means risk. The definition of Khatar is as follows:

"تعليق الملک علي الخطر والمال في الجانبين"

It means to stipulate the ownership/profitability for an uncertain event, whereas money is involved on both sides.

However, if money is not involved on both sides i.e. one party voluntarily declares "We shall compensate you on a particular event of loss", it would not be Mysir.

Gharar means uncertainty. Following are different forms of Gharar:

- Any bilateral transaction in which the liability of any party is either uncertain or contingent.
- Consideration of either is not known.
- Ultimate result of any one party is uncertain.
- Delivery is not in control of the obligor.
- Payment from one side is certain, but from the other side is contingent.

Presence of Gharar, Khatar and Qimar, conventional insurance prohibited.

Qimar

If in any transaction, one party's profit is dependent on the loss of the other, then this is an indication that the transaction involves Qimar.

In other permissible modes, profit or loss is equally shared or is fair to every party. For example, in Musharakah, both parties share profit & loss. Similarly in other trades like sale, purchase, hiring or leasing each party's considerations are certain.

Lets see how Gharar and Khatar exist in conventional Insurance:

Khatar: The participant contributes a small amount of premium in a hop/risk to gain a large sum.

Gharar: The participant loses the money paid for the premium when the insured event does not occur.

The company will be in deficit if the claims are higher than the amount contributed by the participants. This is also Gharar.

The third element in the conventional insurance is riba. The element of riba (Interest) exists in lending or borrowing funds/investments at fixed interest, and other related practices in the investment activities of conventional insurance companies

The Solution: Islamic Cooperative Insurance

(Takaful)

Takaful is an Arabic word that means "Guaranteeing each other". It is an Islamic system of Insurance based on the principle of Ta'awun (cooperation) and Tabarru (gift, give away, donation) where the group voluntarily shares the risk collectively.

Takaful is a pact among a group of members or participants who agree to guarantee jointly among themselves against loss or damage to any of them as defined in the pact.

Basic features of Waqf

- The equity holders of Takaful Company establish Waqf to compensate the beneficiaries or participant of Takaful scheme with utmost sincerity in order to help those faced with difficulties.

- Every policyholder would pay his subscription as donation to the Waqf in order to assist those who need assistance among the participants and beneficiaries of Waqf.

- Any member or participant suffering a catastrophe or disaster would receive a certain sum of money or financial aid from the Waqf, as also defined in the pact, to help him meet the loss or damage he has suffered.

- An example of Waqf is a mosque, a hospital, a Waqf al Awlad, and so on where the beneficiaries of these are predetermined.

A brief structure of Takaful Company

- A Takaful Company is formed with the capital of a group of investors for the purpose of investment into halal business and to compensate the victims of various losses.

- With these objectives, they establish a Waqf from a portion of their capital or from the total capital as per the terms and conditions of that company mentioned in its Memorandum.

- The portion of investment is based on an underlying contract of Musharakah/Mudarabah to invest in halal business and earn a halal profit. Any ratio of profit between the Policy Holder and Managing Partners (Takaful Company) can be determined on the basis of the principles of Musharakah or Mudarabah.

- A portion of Waqf is set apart to help victims of different losses and accidents as per the rules and regulations defined in the Memorandum of the Takaful Company. The ownership of this segregated amount for Waqf goes out from the ownership of Waqif (a person who establishes Waqf), as per the rules of Waqf mentioned in Islamic Shariah.

- The policyholders of Takaful will give away an amount (or premium) as donation to that Waqf to participate in the objectives of fund to compensate their losses as per the rules of the Takaful Company.

- The Takaful Company on the basis of actuary can determine the donation for Waqf.

- The capital of Waqf can be invested into halal and secured schemes of investment, and that Waqf would own any profit and capital gain to that investment.

- Any reserve can be created from the Waqf to mitigate any future losses of that Waqf.

- The Takaful Company can charge a fixed fee or commission from the capital of Waqf for rendering the services of management and adminis tration of this Waqf.

- Any surplus (Faaiz) after deduction of operating expenses and fees may be distributed to poor and/or beneficiaries of Waqf and/or reinvested in the fund again to increase reserves of the Waqf as per the rules of Takaful Company.

- In case of insufficient assets and reserves of Waqf to compensate the policyholders of Takaful, the Takaful Company may arrange a financing or Re Takaful for the Waqf as per the rules of Takaful Company wetted by the Shariah Supervisory board of the company.

- In case of liquidation of Waqf the assets of Waqf can be distributed among the poor and/or participants or beneficiaries of the Waqf as per the terms of the Takaful Company.

- The rules of Waqf for compensation of beneficiaries of Waqf can be predetermined to decide the basis of compensation, extent or limit of compensation, procedure of claiming the compensation and pre requisites of procuring the policy of Takaful.

- In case it is agreed that a portion of premium would be for investment purposes and the other portion would go to Waqf for Takaful purposes.

- The first portion would be considered as investment on the basis of Musharakah / Mudarabah, and any profit/ loss would be shared by the Policyholders and Takaful Company on pre agreed ratios.

- At the time of maturity, this investment would be redeemed on NAV basis.

- However, in this case the other portion of capital would go to Waqf as donation and all rules of Waqf mentioned in the Memorandum would

apply to that amount.

Takaful can be used to cover

- Property e.g. house, factory, mosque, offices
- Vehicles (car, motorcycle etc.)
- Goods (For import or export)
- Valuables
- Health, accidents and life

How Takaful is purified from wrong elements?

Now lets analyze how alternative to conventional Insurance based on Takaful is purified with the wrong elements:

- In order to eliminate the element of "Mayser" the concept of Waqf and Tabarru (to donate, to contribute, to give away) is incorporated. In relation to this, participants shall agree to relinquish as "gift" certain amount of money.

- The Takaful Fund, consisting of the contributions paid as Tabarru, will be further invested by the Company based on the principle of Islamic modes of Trades, through which the element of interest (Riba) will be replaced.

- Through this procedure, the benefit of compensation/ coverage of loss can be achieved easily in the Shariah compliant and reward able way.

Chapter 31

Guarantees and Pledges

A Guarantee contract is permissible in contracts of exchange. e.g. a contract of sale, or contract of rights etc. This guarantee does not affect the validity of the contract in which it is required.

Guarantees in trust (fiduciary) contracts

It is not permissible to stipulate in trust (fiduciary) contracts, e.g. agency contract that a personal guarantee or pledge of security be produced because such a stipulation is against the nature of trust (fiduciary) contracts, unless such a stipulation is intended to cover cases of misconduct, negligence or breach of contract. However it is permissible for the agent to guarantee in his personal capacity and not in the capacity of his being the agent. In this case the guarantee will keep intact even after the termination of Agency Agreement.

The above-mentioned rule will apply to the following contracts as well:

•Wadiah contract
•Amanah contracts
•Musharkah
•Mudarabah
•Wakalah
•Leasing contract where the leased asset is Amanah (trust) with the lessor.

Guarantee Fees

Guarantee Fee

It is not permissible to take any remuneration whatsoever for providing a personal guarantee per se, or to pay commission for obtaining such a guarantee.

Administrative Expenses

The guarantor is however, entitled to claim any expenses actually incurred during the period of a personal guarantee.

Types of Personal Guarantee

Personal guarantees are divided into two types

Recourse Guarantee

This is a guarantee where the guarantor has a right of recourse to the debtor, and this guarantee is offered at the request or with the consent of the debtor.

Non- Recourse Guarantee

A non-recourse guarantee is offered voluntarily by a third party without the debtor's request or consent.

Pledges

Legitimacy of pledges

It is permissible for an institution to stipulate that at or before the conclusion of the contract of a credit transaction the customer shall provide a pledge of security to secure payment, and that possession of the asset so pledged will not prevent it from demanding payment when the payment of the debt falls due.

Conditions relating to a pledged asset

A pledged asset must be a valuable asset that can be lawfully owned and sold. It should be subject to identification by sign, name or description, and capable of being delivered to the creditor. Hence property held in common may be produced as pledge provided that the pledged percentage of it is specified, such as pledge of share.

More than one Pledge

It is permissible to grant more than one pledge on the same property with the condition that the subsequent pledgee should be aware of the previous pledges, in which cases such pledges would rank equally if all were registered on the same date.

In this case, the recovery of their debts from the value of the pledge may take place on a pro rata basis.

But if the pledges were registered at different dates, then their priority to recover the amount of their debts would be determined according to date of registration.

Possession and ownership of the pledged asset

The pledged asset remains the property of the pledgor so far as is continues to be subject of pledge.

In principle, the pledged asset should be in the possession of the creditor. However, it is permissible that it be left in the possession of the debtor and all rules governing pledges remain applicable to such a pledge.

All actual expenses relating to tangible pledges, excluding the expenses incurred for the safekeeping of the pledge, are to be borne by the pledgor. If the pledgee pays for such expenses with the permission of the pledgor, he is then entitled to claim such expenses from the pledgor or to use up to the amount of expenses incurred.

Nature of Hypothecation of Assets as Security

In modern day a new concept of floating charge or Hypothecation charge has emerged. Under this concept, if a customer has taken Rs 1 billion of financing from Financial Institution, the customer provides a guarantee to the Financial Institution to recover the debt by selling the assets of the company. The security is only up to the amount of assets of the company, without specifying the assets of the Company. This structure is not technically a Rahn (pledge) structure and falls under the category of Kafalah (Guarantee)

Chapter 32

Shariah Audit and Compliance for Islamic Financial Institutions

Shariah Audit is an independent examination of financial as well as operational information of Bank; conducted to express an opinion to the stake holders regarding the adherence to Shariah Guidelines, principles by the bank. Incase of any non Compliance noticed, due to any reason, The Shariah Audit will provide suggestions for the remedial / consequential measures.

Strategic Importance of Shariah Audit

Shariah Audit is one of the most important USP for any Islamic Financial Institution since it gives independent opinion about the vary purpose of existence of any Islamic Financial Institution that is its compliance to the Shariah Principles. It is therefore extremely important that a proper system of Shariah Audit is established in every IFI, which should be constantly updated to reflect the latest practices in the growing field of Islamic Banking and Finance.

Responsibility of Shariah Compliance

In principally, it is the responsibility of each and every employee of an Islamic Financial Institution to ensure adherence with Shariah Guidelines in their scopes of work. The direction towards creating a culture where every member realizes their responsibility for Shariah Compliance must be fostered by the Senior Management and supervised by the respective Departmental Heads.

Shariah Audit and Compliance, provides an assessment about the manner in which the responsibility of Shariah Compliance has been exhibited by the Staff members in implementation, Departmental Heads in Supervision and Senior Management in direction setting to ensure Shariah Compliance.

Role of Shariah Advisor/Shariah Board

In any Islamic Financial Institution the role of Shariah Advisor and or Shariah Board is of extreme importance as a policy maker of Shariah Rules and guidelines which are required to be complied by each and every employee of the Bank. At a broader perspective the role of Shariah Advisor and or Shariah Board should cover the following areas.

- Overseeing the activities of the bank in light of Islamic Shariah
- Approves Product concept & documentation
- Check implementation of Shariah guidelines
- Conduct & Supervise annual Shariah Audit
- Issuance of Annual Shariah Report on bank's performance

Guidelines for Shariah Compliance

In order to develop a Shariah Compliance culture in the Islamic Financial Institution, following set of guidelines can be helpful in developing a proper Shariah Compliance framework:

- All Products & Services offered by the Islamic bank must be approved by Shariah Advisor (SA) and or Shariah Board (SB).
- All Agreements used for carrying out transactions must be approved by the SA and / or SB.
- All the financial and accounting entries and related system (both manual & IT) are reflective and in accordance with the guidelines issued by Shariah Advisor / Shariah for every product and procedure.
- The Deposit pool management system/Profit distribution system must be approved by the SA and / or SB.
- The schedule of Charges must be approved by the SA and / or SB.
- Provide guidelines regarding the treatment of different securities taken by the bank to secure their financings.
- Any off-shore or local investment by the bank must be approved by the Shariah Advisor.

Role of Shariah Audit

In order to create good practices and to ensure independent and un-biased assessment of Shariah Compliance in Islamic Banks the Shariah Audit function should be an independent unit reporting directly to the Shariah Advisor/Shariah Board. Any independent Shariah Audit function is expected to perform following roles:

- Shariah Audit (Shariah Audit) will evaluate whether the activities of the bank are being performed as per the guidelines issued, from time to time by Shariah Advisor and or Shariah Board of the bank.
- A periodic audit & compliance review report should be submitted to the Shariah Advisor, and top management of the Bank by Shariah Audit.
- Shariah Audit will evaluate that the accounting and procedural systems are being prepared and run in accordance with the guidelines and policies issued by SA / SSB.

Shariah Audit Methodology

Shariah audit involves review of the following:

1) Documentation, Procedures and Implementation
2) Deposit
3) Investments of the Bank
4) General Environment and Staff Understanding

1) Documentation, procedure and Implementation:

In order to assess the Compliance of Shariah guidelines in the financing transactions of the bank, the following types of Documentations are reviewed by the Shariah Audit:

a) Master Agreements
b) Transaction Documents
c) Security Agreements/Documents

Master Agreements:

- Master Facility Documents are generally Memorandum of Understanding between client and bank and signed at start of the relationship between client and bank.

- This document contains the information regarding the Credit Limit of the Client, Terms and Conditions for the transactions, Securities and Guarantees provided from client and Specific documentation required for every transaction.

- These documents are assessed to ensure that guidelines of Shariah Advisor and or Board are complied with in the execution of these Agreements.

Security Agreements/Documents:

- Security Documents are those documents which bank require from the client to secure its debts and secure it self from any negligence of client. Some of the security documents are as follows:

  - Letter of Hypothecation
  - Letter of Lien
  - General Financing & Collateral Agreement
  - Promissory Note.
  - Letter of Pledge
  - Guarantee

- Security Documents are assessed by the Shariah Audit to ensure that only Shariah Compliant Securities are taken by the bank and the guidelines regarding the treatment of securities are complied with. For example in Musharakah transaction security can only be encashed in case of negligence and misconduct by other party.

Transaction Documents:

- Every Islamic Financial Product has its own set of documentation which must be adhered to in its proper sequence to ensure Shariah

Compliance. Following Islamic financial Products are generally used in Islamic Banks.

- Murabaha
- Ijara
- Istisna
- Diminishing Musharakah

Product wise Audit Guidelines

Audit Guidelines for Murabaha:

While performing post disbursement audit of Murabaha transaction, Shariah Audit needs to review the following:

- Phrasing and sequence of the Documentation of the standard Murabaha Financing is not changed with out approval of Shariah Advisor.

- Subject matter should be Halal other than currency, gold and those things where the ownership / Possession of the bank and its transfer to the customer is ambiguous. Description of assets sold by the Bank should be quantified and specified

- It must be ensured that the offer and acceptance should be signed when Bank has purchased and taken the delivery of goods and those goods are in ownership and possession of the agent / bank.

- It should be ensured that goods are not consumed before the offer and acceptance.

- It should be ensured that the goods, which are purchased by client as an agent of the bank, are not already in the ownership of the client.

- It must be ensured that the Invoices provided by the supplier are genuine and reflects the relevant industry practices.

- Murabaha should not be rolled over.

- It must be ensured that the Murabaha transaction should not be rescheduled by increasing the price.

- It must be ensured that profit is not accrued by the bank before execution Offer and acceptance with the client.

Audit Guidelines for Ijarah

- While auditing Ijarah transaction it should be assessed that the Ijarah agreement being used is approved by the Shariah Advisor.

- Ensure the Ijarah agreement is signed at the time of the delivery of asset.

- Ensure that the bank has taken the ownership and possession of the asset before giving it on Ijarah.

- Asset should be used for Halal Purposes only.

- Sale and lease back, if approved by Shariah Advisor, must take place through two independent agreements of sale & then Ijarah.

- It must be ensured that at the end of Ijarah the asset is transferred, if needed and not necessarily, to the customer by executing a proper Sale Deed or Gift Deed.

Audit Guidelines for Istisna Transactions

- Conditions of Istisna are same as conditions of sale, except for the fact that in Istisna a commodity is transacted before it comes into existence.

- Therefore it must be ensured that all conditions of sale should be complied while executing Istisna transaction except the delivery condition.

- Ensure that the bank do not sell the goods of Istisna before taking possession.

- It must be ensured that the goods were not identified and specified at the time of execution of Istisna Contract.

Audit Guidelines for Diminishing Musharakah Transactions

While performing audit of Diminishing Musharakah transaction, Shariah Audit needs to evaluate the following:

- Phrasing and sequence of the package of the standard Diminishing Musharakah agreement used is approved by the Sharia Advisor.

- Ensure the each step of the transaction is followed by the next step & only the relevant document of that step is executed.

- This arrangement should not be used for cash financing

- Ensure that joint ownership is created in a proper manner.

- Expenses are distributed according the proportionate ownership in the asset.

- Ensure that the rental Agreement is executed only after bank has taken possession of the asset.

- Ensure that offer and acceptance is executed between the bank and the customer to evidence.

- Evaluate that early termination is done as per the guidelines of Shariah Advisor and or Shariah Board of the Bank.

Guidelines for Auditing Deposit Side

Following guidelines are useful for auditing deposit side of an Islamic Bank where deposits are taken on Mudarbah basis and the funds of the depositors becomes part of a deposit pool.

- Mode of deposit acceptance Musharakah, Mudarabah or Wakalah is clearly known to the Depositor.

- Sources & Utilization of funds are
  - Identified
  - Balanced

- Risk & rewards are properly marked against each asset/deposit.

- Proper profit sharing ratio or weightages are assigned at the beginning of the period

- Profit generated from depositor's pool is calculated & shared as per the guidelines

- Losses, if any arises, must be shared in the pool as per the proportionate share of each depositor.

General Environment and Staff Understanding:

- In a broader view the Shariah Audit must not be limited to Financing activites but it must also cover the General Environment and understanding of the branch. For this purpose following areas must be explored and assessed.

- The dresscode of employess is in accordance with the Islamic Culture.

- The attitude of the staff in their customer dealings and their dealing with collegues is in accordance with the values and ethics of Islamic Shariah.

- Understanding of employee about basic concept of Islamic Banking must be assessed.

- Fatawas and all other shariah and product related Polices, guidelines and FAQ are available in the branch.

- Assess the status of training of the staff.

Conclusion

For any Islamic Bank, Shariah Compliance is the most important area, it is not a matter of choice but it is the purpose of existence therefore all banks must need to build Shariah Control system to ensure Shariah compliance in each and every aspect of the Operations of the Bank.

Chapter 33

Examining the Prudence of Islamic Banks: A Risk Management Perspective

Risk Management in Islamic Banking: An Applied Perspective

Before we discuss the Risk management practice it is important to understand basic guidelines about Risk in Islamic Shariah, some of them are as follows:

1. It is not allowed to earn money without taking risk of an asset.

2. Risk alone cannot be sold or transferred with a consideration without transfer of ownership of the asset.

3. On voluntary basis, one can assume the risk of other/s.

There are different types of risks in the trade and there are various ways available to mitigate these risks. We can name these tools as Shariah Compliant Risk Mitigating tools. First, we compare what are the types of Risks in Conventional banking and Islamic banking.

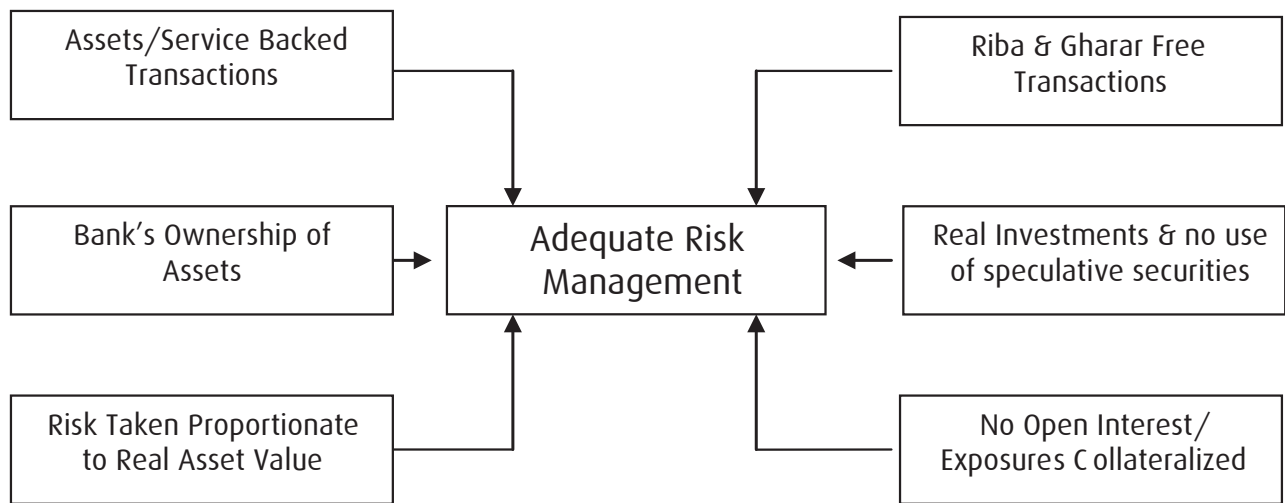
Risks in Conventional and Islamic Banking

Risk Management is a continuous and vigilant process. It is an activity more than an action. It is designed to manage the risks inherent in the bank's business. The goal of an effective Risk Management system is not only to avoid financial losses, but also to ensure that the bank achieves its targeted financial results with a high degree of reliability and consistency.

A conventional bank is generally exposed to the following types of risks: Credit Risk, Market Risk, Liquidity Risk, Operational Risk, Regulatory Risk, and Reputation Risk. A Conventional bank lends money and earns interest on the lent money. It lends money for any financial need, be it for the purchase of assets or not. Even, if it provides financing for the purchase of assets, it does not own the assets and is only concerned with the return of its principal amount and interest. Therefore, it avoids facing many risks that Islamic banks have to face due to their Shariah compliant operations. However, the flipside to this is that conventional banks -by way of freedom to lend money only- get themselves involved in excessive leveraging and their money based financial assets are theoretically exposed to unlimited risks as compared to Islamic banks who by way of asset backed financing are exposed to risks only to the extent of diminishing value of the real asset.

An Islamic Bank faces variety of risks in addition to the risks faced by conventional bank i.e. reputation risk, shariah non-compliance risk, product/mode of financing risk, process risk, counterparty risk etc. Apparently, Islamic banking transactions look more risky as compared with the conventional banking transactions. But, if we thoroughly consider many

prevalent products of conventional banking and finance, we can easily differentiate that Islamic finance has limited risks on its assets as all financing provided by Islamic banks are real asset/service backed. Following chart shows the Risk Management framework in Islamic Banking.

Risk management Framework in Islamic Banking

Risk Mitigant Tools in Islamic Banking

There are different Shariah compliant ways to mitigate or minimize the risks mentioned above in Islamic banking which are as follows:

1. Innovation in collateral arrangements. This mitigates the credit and default risk. Credit and default risks are more important in Islamic banks as rollover and sale of debt at a discount/premium is not allowed in Islamic Shariah.

2. Third Party Guarantees. This mitigates the credit, default and counterparty risk. This ensures that the bank has recourse to cover its actual losses incase the counterparty defaults.

3. Seeking credit ratings of clients from specialized and credible institutions. This mitigates credit risk, default risk, counterparty risk, information risk and asset quality risk. Furthermore, it solves the problem of moral hazard and adverse selection arising from asymmetric information.

4. Selection of appropriate financial instruments available in the Islamic financial product mix to manage risks profitably. Appropriate use of Islamic financial instruments in a particular transaction mitigates process risk and liquidity risk. Wrong use of a mode of financing may result in profits going into charity or the bank having to disinvest immediately creating liquidity crunch for the bank.

5. Precise cost estimation so that price is quoted after adding an appropriate profit margin for Islamic banks to cover the market and price risk. This mitigates transaction risk and price risk. It ensures that over the period of the term of financing, the bank is able to cover the actual direct costs it incurred incidental to ownership and earns a profit is well.

6. Takaful coverage (an alternate to conventional insurance) to hedge against unforeseen events which can shorten the life of the asset and its effectiveness. This mitigates subject matter risk against fire, theft, marine accident, shipment failures etc.

7. Making prior shariah approval for all financing transactions necessary to ensure Shariah compliance mitigates reputation risk. Furthermore, apprehensions about Islamic Banking are removed by publishing and distributing books on Islamic Banking, arranging seminars, designing and delivering Islamic banking courses, workshops and various training programs.

Islamic & Conventional Banking Operations: A Risk Management Perspective

Now we will compare briefly the investment operations of Islamic and conventional banks. Following is a list of securities and investment operations which are very risky and prohibited in Islamic Shariah. But, they are allowed and used in conventional banking and finance and have caused financial crisis in East Asia in 1990s and even more severe and disastrous financial and economic crisis today, the depth of which is still not known.

1. Securitization of Receivables without being 100% backed by fixed assets.

2. Issue of bonds especially junk bonds and convertible bonds which can disrupt the company's capital structure without it being willing to do so.

3. Short selling of stocks, commodities and other securities.

4. Future and Forward transactions in stocks and commodities.

5. Sale of Debt or Debt Swap which increases the size of financial claims and not the real assets and hence eventually brings inflation in the economy.

6. Discounting/Factoring of Receivables. The difference between the discounted value and par value is Riba and hence it is not allowed.

7. Buy back agreements, and Repos/Reverse Repos.

8. Margin financing which multiplies the investment one can make and hence increasing the leverage. In economic downturns, it may result in loss beyond original investment.

9. Lending financial securities as financial securities themselves are just equivalent to cash i.e. consumables and hence no consideration can be asked or given as the case maybe on consumables. Permissible Financial securities (not involving Riba and Gharar and conforming to other Islamic Shariah rules) can only be sold with transfer of ownership as well as risk.

10. Derivatives like Forwards, Futures, Swaps, Credit Default Swaps, FRAs, Put Options, Call Options, Straddle Options etc.

11. Hedge funds which take on unnecessary risk and make capital markets more volatile wherever they go.

12. Credit sale of currencies for speculation.

13. Other similar transactions.

Concluding Remarks The above mentioned transactions involve either Riba and/or Gharar. Therefore, they are not allowed by Islamic Shariah and if we analyze the current financial crisis, we would find that a major cause for such crisis is rooted into the use of Riba and Gharar based transactions. If the rules of Islamic Shariah are followed, we can save ourselves from very risky transactions ensuring smooth running of the financial institutions and hence the economy. Furthermore, the objectives of fair distribution of wealth based on real business and productive enterprise will be achieved as Islamic Shariah only permits taking on risk proportionate to the real value of asset and not beyond the value of the real asset.